FINANCE FOR SMALL ASSOCIATIONS

Sharon K. Mellor, CAE

Sound financial management is particularly critical in small associations. Lean budgets mean that the organization must be operated efficiently in order to provide members with good value for their dues dollars. As executive director, your responsibilities include keeping financial records, preparing accurate financial statements, budgeting, safeguarding and managing the organization's assets, and complying with federal and state reporting requirements. In most cases you will have an elected treasurer and sometimes a finance or investment committee to provide oversight and input. You will be reporting on the financial activities to the board of directors.

This session is designed for association executives who find themselves leading organizations with small staffs. You probably have "earned your stripes" in other areas of association management: membership, communications, or government relations. Like you, I am the executive director of a nonprofit organization with a staff of three. I'm executive director of the American Academy of Periodontology Foundation, the philanthropic arm of the American Academy of Periodontology. We have assets worth about $9 million. When I graduated from MBA school, I thought I knew everything there was to know about running an organization. Boy was I wrong! I am still learning about this area of management that is so important to all of us.

My purpose is not to tell you everything you need to know about association finance. Rather, it is to help you understand the general areas you need to think about and to give you some practical tools to implement. My intent is to help you feel confident in the basic areas of association finance, and also to help you to know for what functions you will need an outside expert. I am not a CPA or a tax attorney, so please don't ask me about current FASBE rulings or specific tax codes. But I would be pleased if you participated in this learning session by sharing your experiences and asking questions of all of us. I view myself as your guide as we explore budgeting, financial reports, internal and external controls, and investing so that you will be better prepared to face these functions in the wild. Some of the information I will be sharing with you is from books, some from experts in the field, and some from my personal experience.

The Association Forum of Chicagoland has developed standards for executive director financial management. They suggest that our responsibilities are:

- **to develop, recommend, implement, review and manage the budget according to policies established by your board and to generally accepted accounting principles.**
- **Develop systems and policies to monitor and manage financial activities. They should include establishing internal controls to safeguard assets, ensuring the accuracy and reliability of financial records, and assuring compliance with laws and regulations.**

- **Ensure that the financial records are audited at least annually by an independent third party.**
- **Develop, recommend, implement, and review investment policies and manage or oversee the management of investments.**
- **Provide timely and complete disclosure of financial information**
- **Maintain current knowledge of applicable local, state and federal tax laws and regulations related to the association's tax status and ensure compliance.**
- **Establish mechanisms to report potential conflicts of interest and take steps to prevent any actual conflicts.**

In other words, as Executive Director, you must do your best to keep your organization out of financial trouble. Is there an early warning system to let you know when your ship might be headed toward the rocks? I would like to share with you 9 clues from the Center for Association Leadership that your organization might be heading for financial trouble:

1. **You are running a deficit from operations—either a small amount for more than three years, or a large deficit, say more than 10% of your available reserves.**
2. **Your available reserves are more than 50% below the target level established by your board.**
3. **Your revenue from two or more of your five largest income sources has declined in more than 2 of the last five years or has declined more than 10% in any of the last five years.**
4. **The number of paid members at your annual conference has declined in more than 2 of the last 5 years or by more than 10% in any of the last five years.**
5. **The net profit from a significant association activity is significantly below what you planned.**
6. **You have had to defer paying bills more than once in the last two years.**
7. **Financial data being provided to your board is incomplete, unclear, or delayed.**
8. **Your auditors have reported numerous weaknesses in your internal controls.**
9. **You are convinced that your financial situation needs serious attention, but you're not sure what to do!**

If two or more of the above clues could be applied to your association, don't panic! But it is time to evaluate all aspects of your financial management and find out in which areas your processes need to be shored up. I found myself facing this exact situation at the end of 2001. We experienced negative earnings for the year on our endowment, so we had to dip into our reserve funds to make our grants and awards for the year. Our annual operating income also was lower because we depend on special events at our annual meeting for revenue. Our annual meeting in 2001 was shortly after September 11 and many members and spouses didn't come. So, based on these indications I felt I had to take a serious look at all our financial processes.

For today's discussion, let's start with your key financial management tool—the budget!

Budgeting

The budget as a tool.

The association budget is typically prepared for 12-month time periods and is an important financial management tool. The association's 12-month time period (or fiscal year) may be a calendar year beginning January 1 and ending December 31 or may begin or end at any other time of the year—i.e. July 1 through June 30. A budget is:

- **A plan**
- **For receiving and spending money**
- **In specific categories**
- **To accomplish programs and projects**
- **Within a set period of time**
- **With monitoring mechanisms as part of the process**

Both the PRODUCT and the PROCESS of developing a budget are useful in many ways to you as the executive director. It is both a means to an end and an end in itself. First, budget preparation helps you to think through various products, services and corresponding costs, and prioritize. The budget lets you, your staff, and the leaders know the goals to be achieved, the work to be done, the resources needed to accomplish the work, the time table for getting specific work done, and the individuals responsible for the work. Your budget should neither be blindly adhered to or tucked away in a file cabinet. It should be consulted, monitored, and modified on a regular basis. It is an ongoing process, not an activity that ends when the board approves the budget.

The budget is an ongoing tool to help you—not a straight jacket! The budget

- **helps integrate administrative and operating activities**
- **helps asses your organization's immediate and long-term financial situation**
- **The budget also is used as a tool against which the actual income and expense results may be compared on a continuous basis so adjustments can be made. Conditions and situations change, and the budget must remain flexible enough so that resources may be shifted as necessary.**
- **The budget also may be used as one measure of your performance as executive director.**

Types of budgets.

The most basic type of budget is the *operating budget* which details income and expense expectations for all association functions, such as administration, governance, membership, meetings and conventions, publications, etc.

A second type of budget is the *cash budget* which is developed from the operating budget. The cash budget indicates when expected revenue will be received and when expected expenditures will be made. This information, along with expectations regarding earnings from investments, allows the executive director to estimate cash flow to ensure that cash is available to meet needs. It also identifies those times when surplus cash will be available for investment. Cash is the life blood of all organizations. It is critical to understand and track your organization's cash flows.

A third budget is the *capital budget*. This budget is used for planning for additions, replacements or improvements in such assets as the association office or equipment. Capital expenditures are not included as part of the operating budget because they affect the association's operations for many years. Only the depreciation of capital assets is

included in the operating budget. Capital expenditures are, of course, included in the cash budget.

How to prepare an operating budget.

It is easy to create a budget for a new fiscal period by taking the current year's income and expenditures and adding a percentage for price changes. Is this a good strategy? The answer is No, because this approach can magnify inefficiencies from year to year. Another method is to first estimate expenses for the year, and then to assume income to cover those expenses. Is this a good strategy? The answer is No, because with this mindset it is easy to overlook trends, such as declining meeting revenue, in the attempt to prepare a balanced budget.

Perhaps the best approach is to first make a realistic estimate of income for the year, then build the expense budget.

Seven steps for creating a budget are:

1. **Examine your mission. What is your organization's purpose? What programs are you providing to your stakeholders? At the AAPF, for example, we exist to provide scholarships, fellowships and research support. So my first step in budgeting is to take a look at our core programs that we plan to fund for the next fiscal period.**
2. **Identify anticipated sources and amounts of income from each activity. Investment income, dues, advertising, meeting registration, etc.**
3. **Set specific goals for each program**
    a. **Outcome goals—what program is expected to accomplish, i.e. provide two $50,000 fellowships for young faculty members.**
    b. **Activity goals—measurable statement of activities to help program reach outcome goals, i.e. print 250 application packets for this new fellowship program and mail the to program directors and dental school deans.**
4. **Prepare a detailed work plan for activities, including time frames**
5. **Identify all resources needed to implement work plan**
6. **Determine the costs of all resources**
7. **Prepare the budget**

First, look at the association's strategic plan in order to identify the programs the organization expects to carry out during the budget year. The executive director must then estimate the revenues generated by each program or function. Income categories might include membership dues, meeting registrations, sponsorships, exhibit fees, charitable contributions, investment income, etc. Historical data from your organization and comparative information from other organizations is helpful when you are determining prices for your products and services, as is cost. You should set pricing and fees to reflect the value created for your members and to achieve your financial goals.

The executive director must then estimate the costs of carrying out those programs. The first type of cost is direct cost. Broad categories might include staff travel, volunteer travel, printing, and postage. To identify the costs for these specific line items you can use past experience, catalogs, and quotes from vendors.

The budget must also include indirect costs (such as space, staff salaries and utilities.) Some budgets are constructed so that direct expenses and income are shown for each individual function or project while all indirect costs are shown under a heading like

"administration". Other budgets are constructed so that a portion of overhead expenses are charged against each project or function. Associations sometimes feel that this second method provides them with the "true cost" of an activity. To prepare a budget of this type, for example, the association executive director would need to estimate the percentage of staff time that each staff member would spend on a particular project, then add this percentage of the salary total to the project expenses.

At the AAP Foundation, we keep daily time logs tracking the number of hours we devote to particular projects. Salaries and benefits are charged against these projects according to the percentage of time each staff member spends on the project. This provides us with good information about the true cost of the activities. But this can also be a double-edged sword. Take our golf tournament, for example. If you look at revenue and expenses, it looks like the tournament makes a tidy profit. Once you charge salary and benefits against it, the tournament barely breaks even. So a certain segment of our board is all for eliminating this activity because "it doesn't make money." But it is my job to encourage them to look at the broader issues. First, if we did not have the tournament, would those staff hours be put towards a project which generated larger revenues? And are net revenues the only and best measure? Last year, for example, one of our fundraising chairs played golf in a foursome with three likely prospects. He walked away from the tournament having secured $40,000 in pledges for one of our program endowed funds. Would he have secured those pledges somewhere else other than the golf course? Maybe . . . and maybe not. So, its important to look at the opportunity costs of other activities that you forgo and to look at the potential for your programs beyond revenues and expenses. While the net revenue for the tournament itself is not much, it does provide us a platform from which to raise money for other programs.

Once the revenues and expenses have been estimated, the executive must ensure that sufficient revenue will be produced to cover the expenses. A first draft of the budget almost always shows the expenses will exceed revenues! This means you must sharpen your editing pencil and look for ways to trim costs by scaling back projects, or looking for less expensive means of achieving your objectives. Some common strategies for trimming the budget include:

1. **Have new vendors submit competitive written bids for purchased goods and services.**
2. **Analyze the use of service agreements for maintenance and repair of equipment rather than paying per occurrence.**
3. **Seek economies of scale in purchasing. Perhaps you could explore the possibility of entering into mutually beneficial cooperative purchasing agreements with other associations in your geographic area. Defer or eliminate low-priority purchases.**
4. **Delay starting new activities or expanding existing ones**

Once you achieve a balance between revenues and costs, the budget should be submitted to the association's elected leaders for approval.

A typical format might look like this: [include budget for organization x]. In the far left column you will find the income and expense categories. Income: investment income, membership dues, meeting registrations, corporate sponsorship, advertising, annual donations. Expenses: salaries, benefits, rent, printing, postage, staff travel, volunteer travel, legal fees, telephone, consultant fees, equipment rental. Across the top

you will find the specific programs: membership, annual meeting, publications, special events. This budget is presented as a comparison to budgeted and actual revenues and expenses for the previous year. Current fiscal year revenues and expenditures to date are also an important part of the overall budget package. This is an important component so the board can determine if the proposed budget makes sense in light of actual financial performance for the current year to date. You also will want to include budget narrative explaining or expanding on any items of significance in the budget. For example, if you project any significant changes in income or expense, you will want to provide the board with your reasoning.

In the budget packet that goes to the board you also may want to include a brief listing of descriptions of each program, a summary of your goals and objectives, a summary of budget policies, and a summary of assumptions used for preparing the budget.

What if . . .

Make sure the budget includes designated reserve funds that your organization can access if revenue projections fail, unforeseeable expenses arise, or unexpected opportunities present themselves. If you currently have no reserve funds, have the board address this issue and set a goal of creating a specified reserve amount over the next two or three years. Some organizations use certain kinds of expected income as reserves. For example, let's say you just entered into a royalty income agreement with an affinity credit card. The card carries your organization's name and the credit card company pays a percentage of each purchase to your organization. This royalty income is performance based and there fore is not always predictable. It is a new program, so you have no historical data on which to base an income estimate. So the income from this new program could be set aside to build your reserve.

Make sure you have criteria for using your reserves. The purpose is defeated if you can dip into this pot of money for any expense or opportunity.

Board's role in budgeting.

Overall, your board is legally responsible for ensuring that budgets meet applicable laws and regulations, are fiscally sound, and will further the nonprofit's tax-exempt purpose. This means:

- **Develops and reviews the association's mission statement and its specific activities for achieving the mission**
- **Establishes general budget policies**
- **Formally reviews and approves the budget prepared by staff**
- **Regularly reviews reports on budget implementation and plans for any needed corrective action**

Monitoring the budget.

You must create and review a monthly report on actual versus budgeted expenses and income for each program. You should identify any emerging financial problems and develop action plans for correcting them. If any variance is discovered early, relative minor corrective action might be all that is needed. But if the variation is discovered late in the fiscal year, more severe action will be required.

Cash flow budget

Cash flow is the relationship between the amount of cash your association actually has available in the bank during a given period and the amount it needs to pay its bills in the same period. If there is more cash than bills, your cash flow is considered positive. If

there are more bills than cash, your cash flow is negative. Cash flow projections predict when cash will be received each month and compare the amount of cash expected with the amount of anticipated expenditures. Predicting cash flow is simply butting time frames around your transactions. Effective cash flow management requires regular ongoing attention—and not just attention when problems develop. You must identify projected periods of negative cash flow and plan specific actions to avoid shortfalls. You don't want to be in the situation where there is not enough money in the bank to pay your salary!

By preparing a projected cash flow on a monthly basis, you can identify when excess cash can be invested, and when cash flow problems are likely to occur. At a minimum, experts advise that you forecast cash flow for 13 weeks into the future because small organizations do not have enough economic strength to survive a even a short-term cash flow crisis.

Let's say your projections show a cash shortage is expected in the fifth month of your fiscal year. To address it you might: postpone a major purchase, establish a payment schedule for a costly purchase, send out dues invoices earlier to begin collecting income earlier, transfer funds from a reserve account, or look at short-term borrowing. You should be aware that some of these strategies may have negative consequences: loans require interest payments as do purchases paid for by installments. However you do not want to generate ill will with your vendors or a possible loss of credit. Using the capabilities of Internet commerce can be a great way of enhancing cash flow. If you do not have this already, think about accepting credit card payments via the Internet, either directly on your site or through another site. That's another way to improve your cash flow. You also may want to investigate on-line bill payment. This is another cash flow management tool that allows you to remit payment to vendors exactly when they are do as the funds are transferred directly to the vendor's accounts. By using electronic transfer you save labor in that checks do not have to be written, recorded, signed and mailed. In addition, the funds can be held in interest-bearing accounts right up until the moment of the transfer. Electronic banking will allow you to move idle funds to interest-bearing accounts so that income can be earned until the funds are needed.

Budget concepts

As you develop your budget, keep the following concepts in mind:

1. **Good budgets are truthful and accurate and in alignment with the mission statement and strategic goals of the organization.**
2. **Good budgets are prepared based on good financial information.**
3. **Budgets should be adhered to, but should also be modified when necessary.**
4. **Good budgeting can become a basis for better understanding and cooperation between you and your board.**
5. **Good budgeting is not easy, but is crucial for your success.**

Selecting Financial Software

There are literally hundreds of accounting packages from which to choose, all providing a varying mix of features and capabilities. Before you begin to evaluate various offerings, spend some time thinking through your requirements. You should confine your search to software prepared for nonprofits. Not-for-profit accounting software is called on to perform all the ordinary tasks expected of commercial accounting software, plus many

others. Define your reporting requirements, consider the types of transactions you must process, consider any required interfaces (for example, with membership database software), determine system security needs, and consider cost limitations. Be sure to base your final decision on value, not price.

Accounting software offers many advantages to the small association. First, cash flow may be improved by reducing errors and staff labor. Automated postings from journals reduces staff intervention and saves time and money. These programs have built-in functions that flag problems like unbalanced entries that could take a lot of time to locate and resolve manually. And finally, the systems can be used to quickly and accurately prepare timely reports.

Some of the features you should consider include:

- **Security features. Products generally come with automatic safeguards that restrict users from deleting entries. Formal correcting journal entries must be made to change original journal entries.**
- **Table-driven chart of accounts. To be most helpful, the software you select should contain a powerful chart of accounts feature. This feature will allow you to design an accounting system that can produce excellent detail in reports and analyses. It should have an account number structure that allows you to enter enough identifying data so that income and expenses can be sorted by type, program, source, and so on. If the chart of accounts is "table-driven," that means that each complete account number includes a number for the fund, account, division, and cost center. Without this feature, creating account numbers becomes a very time-consuming and unwieldy process.**
- **Electronic transmission capability. Accounting software should have the built-in capability to exchange data with other software products.**
- **Capability to manage multiple entities. If you direct multiple organizations, say, a state specialty medical society and its foundation, make sure that the software you choose can handle the data of several entities at once.**
- **If your organization does fundraising, you will need a package that integrates donor management capabilities. An integrated fundraising/accounting module eliminates the duplicate data entry that would be necessary if you used separate packages with no interface.**

Our Foundation is co-located with our parent organization, the AAP. We are very fortunate because the AAP donates the time of their accounting staff to us. The AAP currently uses association software called Avectra, which has an accounting module which interfaces with the other association management modules, like membership and meetings, and with our fundraising module. Some software packages that have received good reviews in the nonprofit accounting software review are: AccuFund Accounting Suite, Budgetary Control System, Fund E-Z Fund Accounting Software, The Financial Edge, and QuickBooks: Premier Nonprofit Edition.

Financial Reports

Financial records for associations are typically prepared using accrual, rather than cash, accounting. This means that transactions are recorded in the period when the program activity occurs, not when the financial activity occurs. Accrual accounting provides more helpful financial reports because it most accurately links the income and expense from a particular activity. For example, the registration income and meeting

space fees for a convention would be recorded in the period in which the meeting took place, rather than in the period in which the registration fees were received and the period in which the meeting space bills were paid. This way the director and volunteer leaders can tell exactly how profitable the event was. But never lose sight of your cash flows. Using accrual basis accounting makes it more important than ever that you regularly track cash flows and prepare forecasts. In some cases, bills for your meeting are due before you receive the cash for registrations—so you need to ensure that you always have adequate cash on hand to meet your obligations.

Types of financial reports. Association financial reports should be timely, comprehensive, and clear. A good test of your financial statements is if, after studying them, a non-accountant will have a good understanding of the organization's overall financial activities.

There are three common types of financial reports.

The *balance sheet* has been called "the window into the fiscal heart" of associations. It lists association short- and long-term assets, which can be cash, savings, accounts receivable, securities, buildings and equipment. Cash includes bank checking accounts, any undeposited checks received, deposits in money market accounts, and any other asset that can be readily converted to cash. It lists association liabilities, which can be accounts payable, grants payable, revenue designated for future periods, and notes payable. The difference between association assets and association liabilities is its equity or net assets. One balance sheet is prepared at the beginning of the period and one at the end for comparison purposes. I would recommend quarterly preparation of balance sheets.

While the balance sheet shows how well your association is able to meet its obligations, the *income statement* shows how well your organization has performed in carrying out its reason to be. It details the activities of the association and describes the changes in net assets over the fiscal period.

The *statement of change in financial position* describes the change in cash over the fiscal period. Because accrual accounting includes many non-cash items on the balance sheet and income statement, the cash flow statement provides a true picture of the cash your association generates.

These reports are useful for identifying and understanding trends over time, so they typically are presented along with reports for two previous years.

Financial Controls

Internal controls.

Four important elements of internal control are:

1. **Control cues. You must communicate your expectations about control to all staff members. Appropriate security should be designed and maintained for all computerized records. You should set a good example for your staff.**
2. **Policy communication. You should document your internal control policies and procedures to provide to the auditor and to and to the board.**
3. **Segregation of duties. This is especially difficult in small associations where the number of staff members is too small to execute control functions. Ideally, no one individual should control all aspects of any transaction: initiation (i.e. receipt of a dues payment check), authorization (verification of the payment against the dues invoice), asset**

custody (preparing the check for bank deposit), and recording (entry into the financial record) and verification (reconciliation of the bank statement). In an association with one staff member, a volunteer leader, perhaps the treasurer, should be responsible for some of these duties. For example, in a two-person shop, the segregation would look like this: Executive director: sign checks, complete deposit slips, perform interfund transfers, distribute payroll, reconcile petty cash, record initial pledges, approve time sheets, prepare invoices, and complete check log. Staff: post accounts receivable, mail checks, write checks, post general ledger, reconcile bank statements, post credits/debits, approve payroll, open mail/receive cash, disburse petty cash, authorize purchase orders, authorize check requests, authorize invoices for payment. Consider using a payroll service. Thanks to a steady accumulation of laws and regulations, preparing any organization's payroll is confusing. Just getting the correct withholding amounts for each employee can be challenging. Contracting it out is a good idea. Due to the nature of the payroll business, they must compete on price and service. This adds up to good value and reliable accountability for the small association.

4. **Recordkeeping. Each transaction must be handled rapidly and accurately. To simplify your cash management, consider using a bank lockbox service. Your members send in their dues, for example, to a post office box. The bank opens the envelope and deposits the check into a special account. At the close of business that day, the account is swept clean of cash above a predetermined level and the excess goes into an overnight deposit account paying interest at a market level. Upon your signal, the funds are transferred into a longer term instrument paying higher interest rates. All of this happens without substantive staff involvement until the transaction records are received for reconciliation. Such a lockbox system can improve your internal controls, simplify recordkeeping, and make better use of limited staff time. Generally, lockboxes are found to be most economical for low-volume and high-dollar collections.**

You should keep a list of your internal control procedures. They could include:

1. **Duties should be segregated. Then spell out your plan for segregation.**
2. **Checks received should be restrictively endorsed upon receipt.**
3. **Checks should be deposited the same day they are received.**
4. **Invoices should be approved before payment.**
5. **Only original invoices should be paid to avoid duplication.**
6. **Each invoice should be marked "paid" when the check is prepared.**
7. **Checks should have accompanying documentation when they go to the signor.**
8. **Two signatures should be required for large checks—specify threshold.**
9. **Proper security should be used.**
10. **Supporting documentation must exist for transactions such as loan agreements and rental agreements.**

External audits.

Most small association executive directors, on the whole, would rather not have financial audits. They take up valuable time, disrupt operations, and cost money. However, there are significant benefits to be derived from audits. You should try to look at them as an opportunity for improvement. The benefits to be derived from an audit include: enhanced credibility of the financial statements, professional assistance in developing statements and procedures, advice on internal control, and assistance in tax reporting and compliance requirements. The role of an external auditor is to verify the information contained in the association's financial reports and to issue an opinion whether the reports conform to generally accepted accounting principles. The audit report may contain other information which the auditor feels will be useful to individuals reading the report. The auditor will not examine each and every financial transaction. Instead, they look at a representative sample. The tighter the association internal controls and procedures are, the smaller the number of transactions the auditor will need to examine in order to be satisfied.

There are several different levels of audits. The two that are relevant to associations are the review and the full audit. In a review, the auditor compiles your financial information into standardized formats and then performs analyses to see if it seems to have internal consistency. The auditor offers no opinion, only the assurance that he/she is not aware of anything that would materially alter the statements. State laws make this choice available only to nonprofits with the smallest revenues. In a full audit, the auditor tests management's representations in man y ways according to pre-established protocols. Prolonged exposure to the books and records gives the auditors a greater opportunity to spot errors and omissions and to make suggestions for improvement. Most nonprofit associations use the full audit.

Certified Public Accountants (CPAs) are the professionals qualified and licensed to give an opinion about the financial health of organizations. You can find part-timers who work out of their homes, to small firms with a dozen or so staff members to large international firms. Small associations typically find they get the best value from solo practitioners or small firms.

To select an audit firm, associations typically send out a request for proposal (RFP). The RFP should describe your organization: What is your mission? What is your tax status? What are your programs? Include summary financial information such as revenues and their sources and balance sheet data. The RFP should state explicitly what you need the auditing firm to do. Do you only want audited financials? Or do you want them to complete the tax returns and file various financial reports? You should ask the auditors to describe their qualifications to audit your organization. You should describe your decision timetable, process and selection criteria. Be prepared to meet with each candidate in person.

There are several key factors you can use to judge the proposals you receive:

***Industry knowledge. Most associations find that it is to their advantage to select firms that have similar nonprofit clients and therefore are familiar with applicable accounting standards.**

*** Tax expertise. Membership organizations have many unique tax issues, including unrelated business income tax, lobbying, and publication cost allocations. A deep knowledge of these issues is vital for your auditor.**

*** Price. Typically solo practitioners and small firms have lower overhead than do larger firms. They also may be more likely to negotiate a discount with you.**

*** Name recognition. Some firms have name recognition that confers prestige on their clients.**

*** Staff continuity. When staff leaves it can cause disruption on both sides of the client-auditor relationship. A low rate of staff turnover adds comfort and predictability to the process.**

*** Audit firm size and location. There is a natural tendency for organizations to gravitate toward service suppliers of their own size. Think about what is important to your organization. Think about how important it is for you to have ready access to your auditors. Small associations might choose a small national audit firm for its credability, another might choose a practitioner across the street.**

*** Range of resources. Smaller associations commonly rely on their audit firms to provide financial or other consulting advice. Careful consideration should be given to the consulting capabilities the firms offer.**

*** Technology. An important consideration is whether the firm will be able to work with electronic data from your system.**

Who makes the decision? For the record, the board does. And they should meet with the auditors once a year to get a firsthand account of your association's financial status. But the executive director typically is the one to review the proposals and provide a recommendation to the board.

There are two schools of thought on retaining audit firms. Some associations feel it is best to develop long term relationships with auditors. The audit staff learns about the association processes and records and this helps the audit itself to go more smoothly and quickly. Other associations feel there is value to changing auditors every three to five years. Audit firms approaching the books with a fresh eye may offer valuable recommendations. And associations sometimes feel that the audit process has enhanced credibility by eliminating the possibility that the audit firm has become too familiar and "chummy" with the organization.

You should have a pre-audit conference with the auditor. This meeting should involve planning, identification of areas of focus, and discussion of the audit process. You should always ask for an estimate of fees and for an explanation of how you will be billed. Most auditors provide you with an estimated fee based on the number of staff hours they think your audit will require. Ask if there is anything you can do to ensure that the auditor uses as few hours as possible. After the fieldwork is completed, you should meet again with the auditor to review drafts of the financial statements and the related auditor reports. You will want to discuss any recommendations made by the auditor, and methods for implementing them.

You can keep the costs of the audit lower by making sure that you do your part of the organization's financial work. The more you do, the less they have to do. Ensuring that adequate internal controls and verification procedures are in place. If you fail to reconcile bank statements, prepare depreciation schedules, or enter accounting data, the auditors have to do it instead. If they have to act as your bookkeepers, it will add to their time, and they may find that their independence has been compromised because they are auditing their own work. If the auditor finds significant lapses, it may prevent them for issuing and opinion.

Reading an audit statement. The audit report can tell you a great deal about your association.

First read the opinion letter. The text should read "In our opinion, these statements fairly present . . ." If the auditor lists exceptions or declines to express an opinion, you should be concerned. Common reasons for the auditor to express a qualified opinion are because of accounting disagreements with the way certain information is presented, because your records are in bad shape, or because the CPA fears that your organization may go out of business soon.

Next turn to the notes at the back of the report. This is where a note will say that the accrual basis of accounting was used. This is also where any related-party transactions will be disclosed. Sometimes someone connected with your association will enter into some sort of transaction with you—i.e., a board member may rent the office building to the association. While the transaction may be perfectly innocuous, accounting rules require that materially important related-party transactions must be disclosed. Any lawsuits pending against your association must be disclosed in the notes.

Next, we will turn to the pages with the numbers and use a few simple measures to evaluate the health of your organization. These ratios can give you powerful insight into your organization's financial well-being.

The first is current ratio. This is a measure of liquidity and is computed by dividing current assets by current liabilities. Conventional wisdom states that this ratio should be at least 2:1. That is, for every dollar of liabilities coming due there should be at least two dollars of assets payable to pay them.

Next is cash flow to total debt. This is computed by adding net income and depreciation and dividing the sum by total liabilities. This measure asks how much free cash is available each year to satisfy the liabilities on record. Higher is better for this measure.

Long term liabilities divided by net assets measures borrowed funds against owned funds. Lower numbers indicate low debt load.

Total margin is computed by subtracting expenses from revenue and dividing that answer by revenue. This is your organization's bottom line. It is the fundamental profitability indicator. Generally, you will need profit to generate cash for investment and growth.

Safeguarding Your Financial Position

Operating reserves. Wise associations strive to set aside funds to use as a cushion in times of financial stress. How much is enough? There is not hard and fast rule regarding appropriate levels of reserves. Typically, however, the smaller the association budget, the larger the percentage of the annual budget which should be set aside into a reserve fund. This is because organizations with small budgets have less flexibility in trimming costs during times of financial hardship. According to the ASAE, more than half of associations with a formal reserve policy define their reserve as the organization's net unrestricted assets and have a median target of 50% of the annual operating budget. Other associations, however, more narrowly define operating reserves as liquid assets (cash and investments that can be quickly converted to cash) and have a median reserve target of 33% of the operating budget. The association should set a policy regarding its definition of operating reserves and the level of reserves it feels appropriate. It should strive to reach that goal and maintain the fund at that level. Achieving the operating reserve goal will

enable the organization to ensure its current and future financial health while meeting critical member needs.

Many association's invest these "rainy day" funds conservatively in CDs and fixed income accounts. The association's investment policy should cover the operating reserve fund and detail permissible investments, taking into account the organization's risk profile. The association should also pay attention to the liquidity of the operating reserve funds and concentrate investments in short-term and long-term liquid opportunities.

Mix of funding sources. The association should pay careful trends to its various sources of funding: dues, exhibit sales, advertising, grants, product sales, meeting registrations, investment income, donations, etc. The savvy executive will watch for trends in each of these funding areas and be prepared to act if a particular source of revenue appears to be faltering. Trend-watching is especially important in organizations that depend heavily on one source of revenue. Small associations in particular must pay careful attention to dues revenue. According to the 12th edition of the ASAE's *Operating Ratio Report,* the smaller the association and staff size, the more it relies on dues income as its major source of revenue. To make up for declining revenue in any one area the association may consider cutting the expense budget, reaching out to new markets with existing opportunities, developing new products and services to appeal to new market segments, or reevaluating current offerings. For example, some associations do not recognize the value of their membership mailing lists, if your organization permits selling them to pre-qualified buyers.. Determine through outside sources the real market value of your database and charge appropriately. Some small-staff associations are developing for-profit subsidiaries to meet their needs for increased revenue.

Investments

In the 1990's when stocks and bonds experienced tremendous performance, investment committee members had it relatively easy. Even without a well-conceived strategy, the bull market generated large returns. Those days have passed. I don't expect to see any more newspaper articles announcing that organizations have achieved 58% return on their investments, as did the Notre Dame Endowment Fund for the 12 months ending June 30, 2000. With the start of the new millennium, the stock market declined for three straight years for the first time in roughly 70 years. It used to be that an organization could make income on its investments with practically any strategy. But suddenly, volunteering to oversee an association's investment program no longer is a simple thing. The organization's investment strategy must be crafted to help take advantage of earnings opportunities, and to protect the organization's assets in downturns.

To help you navigate these tricky waters, the AAP Foundation's investment consultants, DiMeo & Schneider have donated two copies of their new book "The Practical Guide to Managing Nonprofit Assets." If you are interested in participating in a drawing for these books, please put your business card in this bowl.

Building an investment program. The first step in building an investment program is to set goals. Answer the following questions:

- **What is the purpose of this investment fund?**
- **Who should oversee the fund?**
- **What are our spending goals and limitations?**
- **What socially responsible investment screens should be used, if any?**
- **What is our time horizon?**

- **What asset classes or investment types are we willing to consider?**

Investment policy. The Board, or a subgroup of the Board such as a finance committee, should develop an investment policy for approval by the governing body. Our investment consultant, DeMeo and Schneider, helped the AAP Foundation prepare a sound and comprehensive investment policy. Our biggest discussion came when we were trying to decide between shooting for a 7.5% return over time, or accepting the additional incremental risk inherent in looking for an 8% return. We had many conference calls and e-mail debates before deciding on 8%. An Investment policy statement accomplishes several things. It states your vision, helps you track progress, and outlines oversight procedures. This is especially important in associations because investment committee members serve limited terms and the constant member rotation can cause the investment program to drift if the organization does not have a written policy.

The policy should address critical areas of oversight. They include:

Spending policy, investment policy, liquidity needs, asset allocation, rebalancing, manager selection, performance evaluation, manager termination procedures, proxy voting, and responsibilities of all parties.

This investment road map should indicate target percentages for such investment classes as fixed income; cash and equivalents; and equities. The policy should address acceptable investments and unacceptable investments (i.e. corporate junk bonds), limits on stock purchases of any specific company, minimum ratings for bonds, and other criteria of importance to the organization. The policy should also address with what frequency the portfolio should be rebalanced.

Asset allocation.

If the total money available for investment is relatively small, many organizations find that a no-load mutual fund is a good answer. A mutual fund pools assets of multiple investors. The mutual funds' prospectus informs investors about the fund's strategy, investment restrictions, risks, performance, expenses, and administrative guidelines. In this way the association is utilizing a convenient way to obtain investment management. There are many mutual funds with different investment goals and varying degrees of risk.

If the organization has a larger amount of money to invest, they might consider utilizing a professional to provide advice on its portfolio. A professional may be retained to provide advice only, or to advise and handle actual buying and selling of investments. The organization may establish specific investment guidelines and restrictions for it's portfolio.

When making investment decisions, you should give consideration to the safety of principal, yield, and risk; stability of income; marketability and liquidity; and maturity. Security usually is given the highest priority for nonprofit organizations.

When developing your investment strategy you and your investment committee should think about the following questions.

- **How much money will be available to invest and for how long? Cash-flow projections should be made conservatively when estimating funds available for investing. The cash budget should provide you with an estimate of cash needs by month, you can use this budget to determine what portion of the cash balances can be invested and for how long.**
- **What portion of funds does your organization want safe and liquid? You can't afford to risk your funds. Is there a portion of money available for more aggressive investing? When timing for cash needs is uncertain, funds must be**

held in short-term and liquid securities. Investments with longer maturities offer higher yields but are less liquid.

- **What should be the mix of investments for diversification? Different investments can be timed to mature when the funds are needed for operating expenses. In formulating an investment strategy, you should investigate the investment vehicles available in the market, determine their relative yields for maturities required, and should assess the differences in risk associated with them.**
- **Most advisors agree that your long-term funds should be broadly diversified by asset class, by market capitalization, and global position.**
- **Always know what you're paying to invest your funds. Ask for a breakdown of all fees, commissions, and compensation charged by your investments and paid to your advisers.**

Investment manager selection. Once you have a blueprint for your investments, your committee members are in a position to hire specialists for each of the areas of investment management called for in your asset allocation. The following steps can be used to select a manager. First, seek input from your board and committee members. They usually are well-connected and have some investment experience. And by soliciting suggestions up front, you lessen the risk of having new manager candidates inserted late in the process. Look for a stable organization with minimal turnover among investment professionals. Then, exclude the managers who have expense ratios above the group average. At this point, you should contact the management firms and ask them to respond to specific questions. You want to assess the history and stability of the organization. Find out if the firm has ever been subject to litigation or censured by a regulatory body. Find out how many members are on the investment team and what their credentials are. What is the succession plan if a key member of the team departs? Make sure the firm has a well-defined investment process. What are the normal minimum and maximum percentages of a total portfolio that would be invested in any one sector, industry, or stock? Also look at performance. You want to see consistency of performance. Examine performance over various market cycles. You will want to find out whether they have a passive or active management style. Passive management is an investment approach that seeks to replicate the performance of a specified index. This is the least expensive approach. Active managers try to beat indexes. You may want to hedge against market cycles by using both passive and active managers for your fund. And finally, you will want to interview the qualified managers before making your selection. Make sue they are accessible and that your association fund meets their minimum size requirements. Make sure you understand their fee schedule. Fees can be assessed on a fixed or performance basis or a combination of both. While fixed fees are easier to monitor, performance-based fees provide additional incentive for results. Also inquire if special fee discounts apply to nonprofit organizations. And ask that the manager provide to you, in writing, that your organization's fees will be at least as low as those of any similar clients of the manager.

Our Foundation hired an investment consultant to recommend managers for the various asset classes and to monitor their performance. This works well for us—we believe we are getting a higher total return because we can take advantage their financial industry knowledge and tools. And our board feels much more comfortable in their fiduciary role that we have investment professionals looking out for us.

Portfolio rebalancing. You spend a lot of time determining your risk tolerance and optimum asset allocation. Then market fluctuations change everything and suddenly your portfolio is out of balance. So when and how often do you rebalance? Traditionally, organizations rebalance their portfolios in one of two ways. The first is time-dependent, rebalancing every month, quarter or year. The second is the percentage method—the portfolio is rebalanced whenever an asset class is plus or minus 5% of the target allocation. An effective rebalancing strategy seeks to minimize rebalancing frequency, thus keeping transaction costs low, while rebalancing frequently enough to minimize drift away from the stated return and risk objectives.

We use new contributions to rebalance our portfolio. We review our portfolio quarterly and rebalance when an asset class is 5% more or less than its target allocation.

Performance monitoring. The purpose of a benchmark is to provide a frame of reference for analysis. You want to know if your rate of return is reasonable when compared with that of an appropriate index. Indexes can be broad-based, which means they are composed of a large number of securities and are designed to represent an entire market's price movement. The most widely used broad-based index is the S&P 500 composite index. A narrow-based index consists of a small number of targeted securities. Quarterly evaluations of the manager's performance against appropriate benchmarks should be sufficient.

Our investment committee receives quarterly reports from our investment consultant. Those reports are presented to our board twice each year.

When do you need an investment consultant? As your portfolio grows, you may reach a point when you realize that your organization may not possess the information and expertise necessary to make good decisions. Your investment committee may not possess direct knowledge and experience in capital markets, they may not understand their legal fiduciary duties, they may not be able to apply a completely objective perspective in decision-making, they may not be able to negotiate favorable terms with investment managers, and they may not be able to commit the required time.

A good investment consultant can add value to your organization by: improving investment performance, helping your board satisfy their fiduciary responsibilities, reducing expenses, providing continuity for an investment committee that has regular changes in its membership, and by helping to develop well-founded investment policies.

Some good questions to ask potential consultants include:

- **Why do you want to do business with us?**
- **What sets you apart?**
- **What is your greatest shortcoming?**
- **How would you foresee helping us?**
- **How many clients have you lost in the past year?**
- **Why?**
- **What steps have you taken to eliminate conflict of interest with regard to fund or manager selection?**

Fees may be assessed on a project basis, on a fixed retainer, or an asset-based retainer. Our consultant works with us on an asset-based retainer. A problem that I encountered during our search, is that two of our board members were strongly recommending that we consider hiring the company who provides their personal

consulting services. When setting our criteria we explicitly stated we were looking for a firm headquartered in Chicago that specialized in nonprofit clients. Those criteria helped us to focus on organizations that did not have ties to any of our leaders.

Communicating with the Board

The executive director should communicate regularly with the board to keep them apprised of the organization's financial status. Especially if there are unexpected financial losses, the executive must inform the board of the extent of the variance honestly and directly.

Tax Issues

Don't think that because your association is tax-exempt, you do not need to pay attention to your tax management process. Your organization is subject to many regulations, including Unrelated Business Income Tax (UBIT) rules and exempt-status preservation rules. You must comply with various federal and state reporting requirements. This function requires both a familiarity with the laws involved and the forms which must be filed. For this reason, be sure to use an experienced exempt organization tax professional to prepare your returns. Your external audit firm may be willing to do this for an additional fee.

You will want to have regular conversations with your attorney as well. Don't assume that because your organization has always done something that it is ok. For example, when I started at the AAP Foundation, we had been having a regular raffle for several years. A company donates to us the lease on a car, and we sell raffle tickets. I mistakenly assumed that this project had been ok-ed by our attorney before it was launched, so I didn't question it. It was not until I had been with the foundation for several years that I found out this fundraiser amounted to an illegal lottery. So, its better to question everything, than to leave your organization vulnerable.

As a non-profit entity, your organization is permitted to generate greater income than expenses. What you are barred from doing is distributing net earnings to individuals who control the organization. Nonprofit organizations are organized to benefit members and the public. Therefore they have no shareholders and pay no dividends—all earnings are reinvested in the organization in furtherance of its nonprofit purposes.

As a tax-exempt organization, the revenue from educational conferences and seminars and other activities that further your organization's tax-exempt purpose is exempt from federal income tax, and likely state tax as well.

Its important that you understand the importance of preserving your tax exempt status. To qualify for exemption under 501 c 6, for example, your organization must mee certain basic tests:

- **Must be an associations of persons w/a common biz interest and organized to promote this interest**
- **Must not be organized for profit**
- **Must be a membership organization and have a meaningful extent of membership support**
- **No part of net earnings may inure to the benefit of any private individual**
- **Its activities must be directed to the improvement of biz conditions**
- **Its purpose must not be to engage in a regular business of a kind ordinarily carried on for profit**

- **It must be primarily engaged in activities constituting its basis for exemption.**

The most significant ongoing threats to the tax-exempt status of a c6 organization are:

1. **Too much unrelated business income (an amount that would cause the irs to conclude that the primary purpose of the organization was unrelated to its tax-exempt purposes**
2. **The provision of too many particular services for individuals (an amount that would allow the IRS to infer that such services were the primary purpose of the organization)**
3. **Inurement of benefit of net earnings to any private shareholder or individual**

Form 990.

All not-for-profit organizations with the designation 501 (c) must file form 990. Form 990-T must be filed if the organization has unrelated business income. Because these forms are written in technical language, associations should consider obtaining competent tax advice for their preparation. The 990 form includes a list of officers, directors and trustees; balance at beginning and at end of year; itemization of revenue and expenses by major activity and/or program; and a description of activities. There is a form 990 EZ which can be filed by nonprofit associations with gross receipts less than $100,000 and total assets less than $250,000 at year end.

You must make your three most recent annual returns easily available for public inspection during regular business hours at your office. Other materials which must be available are your articles of incorporation, bylaws, and your IRS determination letter. In addition, you must comply with requests, made in person or in writing, for copies of these documents.

Documentation.

If an IRS controversy arises, you may be asked to provide documentation. Make sure you have policies and procedures for retaining documentation including board minutes, signed contracts, correspondence, copies of checks, and tax returns.

UBIT (Unrelated Business Income Tax)

As small associations increasingly are looking at programs and services to provide more to the bottom line and to create new non-dues revenue streams, a good understanding of unrelated business income tax becomes more important. Virtually every association is subject to normal corporate taxes on its unrelated business income. Unrelated business income tax (or ubit) have been a fact of life for associations since 1950. The primary objective of this tax was to prevent unfair competition by placing the unrelated business activities of tax-exempt organizations on the same tax basis as the nonexempt business enterprises with which they compete.

UBIT generally results when 3 factors are present: the income is from a business; the business is carried on regularly by the association, and the business is not substantially related to the performance of the organization's tax-exempt functions. For example, if your organization provided association management services, lets say publishing a member directory for another association, the fees you were paid probably would be subject to UBIT.

Let's go over these one at a time. A business includes any activity which involves the sale of goods or the performance of services for profit. "Regularly carried on" means that they are frequent and continuing. The term "substantially related" means the conduct of a business which is closely related to the organization's exempt purpose. For example, if

you are an association, your basic tax-exempt function is providing services to your members in exchange for dues—thus, this is related revenue. How the organization uses the funds from the business in question are no importance in determining whether or not the business is subject to UBIT. Because regulations change, be sure to seek advice from your tax professional.

Even if an activity meets the definition of UBIT, it may be exempt because of one of many tax codes relating to specific exemptions. Specific exemptions include interest income, rents from real property, and royalties.

Once you identify UBIT, you may not have taxable income. Just like with for-profit companies, you are allowed deductions from income for direct expenses, including reasonable allocations of salaries and overhead.

The amount of UBIT will not by itself cause your association to lose its tax exempt standing. There are no specific percentage limitations, but some have noted that the IRS may deny or revoke the tax-exempt status of an organization when it regularly derives more than one-half of its income from unrelated activities.

Royalties. Royalties are excluded in computing the UBIT of tax-exempt associations. Royalties are payment for use of trademarks, copyrights, photographs and member names. If your association endorses a vendor's product or service, in an arrangement commonly called an affinity program, the association does not pay tax if it does not market the program or service. But if the association does market, then the tax issues are more complex. If you are in the process of structuring an endorsement arrangement and want to lower your risk of UBIT, then structure the contract so that your association licenses its name, logo, and/or mailing list; exercises quality control over the use of its intangible property by the vendor, and not much more. The contract should expressly state that it is not intended to create a joint venture or partnership between the parties.

Insurance services. An association that regularly manages an insurance program for its members, for a fee, with a substantial portion of its income and expenses traceable to this activity, could be regarded by the IRS as conducting an unrelated business.

Trade show exhibit income. Make sure you understand the rules as they apply to your trade show. Not all trade shows are tax-exempt. For example, they must be educational in nature and include a cross-section of industry products.

Volunteer-run activities. For 501(C)(3) organizations, activities run mostly by volunteers are tax exempt.

Advertising. Advertising in your publication typically is considered to be unrelated business income, even where the publication itself is related to the exempt purpose of the organization. To be tax-free, it must be part of the exempt function of the organization.

Corporate sponsorship. Sponsorships, where the sponsor receives no more benefit than the acknowledgement of their name or logo, generally is exempt.

In summary, you should pay special attention to the revenues from the following activities, which may be subject to UBIT:

Advertising in any organization publication, associate member dues, mailing list rental or sale, affinity program revenues and management fee revenues.

Summary

As executive director, you are in the position of preserving and using the organization's assets on behalf of the membership. One of your most critical responsibilities is learning to discharge these responsibilities in an effective and efficient manner.