Profitable Solutions For Nonprofits

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How well are you doing in the numbers game?

Ratio analysis provides valuable insight into your financial future

More nonprofits are recognizing the benefit of financial performance measurement as a strategy for evaluating operations, programs, services and financial stability. One useful measurement tool is financial ratio analysis. It involves taking data from your financial statements, using it to calculate ratios appropriate for your not-for-profit, and then benchmarking those ratios against past performance, management objectives or other organizations.

Financial ratio analysis can help you assess your nonprofit's overall financial condition and flag financial patterns that might be harmful. It could be the winning strategy you need to stay ahead in the numbers game.

When starting out

Before you begin figuring out financial ratios, you'll want to determine what you want to learn about your organization. Customary questions include:

- Are our financial resources applied efficiently and effectively to support our mission?
- Is there an appropriate match between the sources from which our resources are derived and their use?
- Are our present resources sustainable?
- What sources of funding are available to support our mission?

Helpful ratios

Once you state your goals for financial ratio analysis, it's time to quantify your financial information. Here are some ratios every nonprofit can use:

Viability. It compares expendable net assets (including unrestricted and temporarily restricted net assets) to long-term debt. This ratio indicates a nonprofit's relative liquidity or its ability to convert assets to cash. It serves as a basic indicator of financial strength, because it measures the availability of cash and other liquid assets to meet the organization's financial obligations.

Primary reserve. This ratio addresses the question of whether resources are sufficient and flexible enough to support your mission without having to borrow externally. It compares expendable net assets to total expenses. It describes your organization's ability to fund program and other expenses from expendable net assets should no additional operating revenue be available.

Change in net assets. It measures financial performance by answering the question: "Did your organization live within its means during the year?" The net income ratio is the extent to which your nonprofit's total operations resulted in either a surplus or a deficit. It's based on unrestricted resources.

Operating margin. This is an important forecasting ratio because it illustrates your nonprofit's potential surplus, which could be drawn on if needed in future years. It's determined by subtracting expenditures from revenues and dividing that sum by your revenues.

Program efficiency. It compares total program expenses to total expenses. Having this information can help you determine the administrative overhead you'll need to run your programs. It will also assist in your budget planning and forecasting, as well as keeping you on target to accomplish your goals.

Operating reliance. To show how much your nonprofit is able to pay for total expenses solely from program revenues, divide program revenues by total expenses.

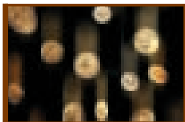
Fund-raising efficiency. Do you know how much you're generating from fund-raising activities? This ratio indicates the amount of contributions that result from fund-raising expenses by dividing the former by the latter.

As you consider the various ratios, identify which ones are relevant to your organization. Then select appropriate benchmarks and determine what the comparisons might indicate. Keep in mind that, just as a manufacturing company and a gas station chain are in different businesses with different financial indicators, a specific ratio will have different meanings to different nonprofits.

Get ahead

Used monthly or yearly, financial ratio analysis can help you get ahead in the numbers game by providing you with valuable insight into your organization's financial future. By using this tool, you'll be able to identify strengths and weaknesses — and take appropriate action in time. ✧

How to choose the right cost reporting methods for your nonprofit



The IRS requires not-for-profits to report expenses according to whether they were accrued for program services or for supporting activities, including fund raising, management and general, and, where applicable, membership development. It sounds simple, but as every nonprofit management team knows, it isn't.

Reporting many direct program costs is pretty cut and dried. For example, the cost of boxes clearly can be assigned to the holiday food distribution program, and the space you use for the latchkey children's program to your overall after-school outreach.

Reporting indirect costs gets much stickier. How much of the executive director's salary should be attributed to after-school outreach and how much to adult literacy? Is a direct mail postcard that includes both health information and a request for donations educational (and thus a program expense) or a part of your fund-raising campaign? How do you divide your cost for office supplies among individual programs?

Deciding which costs are direct and indirect

The instructions for IRS Form 990 provide some guidance, and Financial Accounting Standards Board Statement No. 117, *Financial Statements of Not-for-Profit Organizations*, offers additional direction. Ultimately, though, it's up to you to decide how to designate, account for and report your expenses.

The first step is to decide which expenses are direct and which ones are indirect. Although many direct costs are clear cut, others are not.

For example, you can assign the time a director spends developing and overseeing programs to those programs as direct program expenses, or you can allocate the entire director's salary as an indirect expense. Either approach is fine, so long as it's based on internal guidelines that are reasonable, justifiable and consistently applied.

For nonprofits that receive federal funding, be sure the allocation of time is supported by timesheets or timecards. Otherwise, the cost may not be allowable.

Keep in mind, you may be able to turn some indirect expenses into direct ones with careful tracking.

Sizing up indirect costs

Any management and general costs that can't be directly tied to individual programs but that do help support them are indirect costs. Once you've identified indirect expenses, you must decide the best way to report them. Here are four methods to consider:

1. Actual usage. It allocates expenses by compensation. Because payroll and related benefits are usually the largest program expenses, this allocation is often the driver of allocation methods. This is probably the most accurate method because it's based on time records.

2. Simplified-allocation. If you have only one major function that encompasses a number of programs or if all your major functions benefit roughly equally from indirect costs, the simplified-allocation method may be best. It entails dividing indirect costs equally across all programs. Although it may be easy to administer, it may lack accuracy and small programs bear a larger burden of indirect costs.

3. Multiple-rate. If you have multiple functions that benefit unequally, you'll need to prorate indirect costs across the programs according to the approximate percentage of the benefit each receives. If your nonprofit has to develop an indirect cost rate, you must follow federal guidelines.

4. Direct-allocation. Under this method, you separate costs into three categories: 1) general administration and expenses, 2) fund raising, and 3) other direct functions. General administration and expenses are reported as indirect costs — using the simplified-allocation technique. The rest are allocated to the benefiting cost category.

Keep in mind, you may be able to turn some indirect expenses into direct ones with careful tracking, such as by reviewing long-distance telephone bills, logging copying expenses and using timesheets to determine how many staff hours each program requires.

But though the record-keeping can be effective, it's usually burdensome. Plus, there are many expenses, such as heating hallways and restrooms, that can't be easily measured and assigned. That's why indirect cost allocation methods are so important.

Finding a base

For each method, you'll need to select an equitable distribution base for each category of expenses. Equitable distribution bases are usually determined by the cost benefit to your organization and what is allowed by funding sources, such as grantors. Examples of bases include square feet of space, or number of employees or clients.

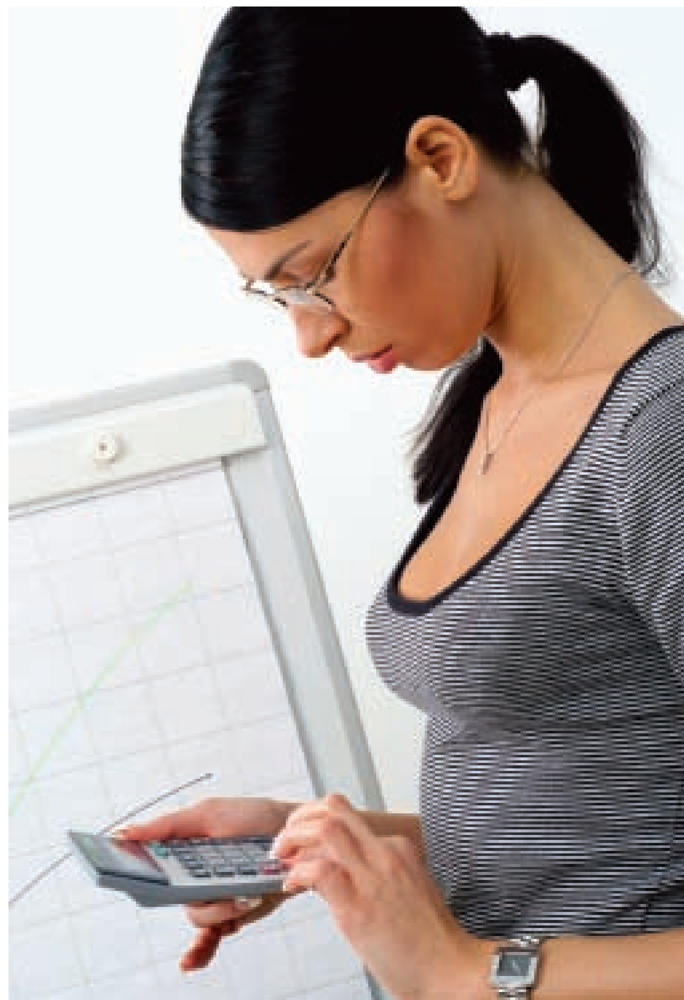
Let's say, in a simplified example, that your total annual budget is $100,000. Of that, $75,000 is directly attributable to programs. The remaining $25,000 in indirect costs is spread across five programs: caring, sharing, helping, assisting and guiding.

What doesn't count

There are some indirect costs you can't allocate to programs under federal regulations. So make sure you don't include any of these expenses in your indirect costs:

- Alcoholic beverages,
- Bad debts,
- Contributions,
- Entertainment,
- Fines and penalties,
- Personal goods and services,
- Fund raising,
- Lobbying, and
- Selling and marketing.

There are other costs, such as special capital expenditures, that may also be excluded if they would skew the totals unrealistically. Check with your financial advisor to learn how to handle them.



The caring program has 100 clients, sharing has 250, helping has 25, assisting has 75 and guiding has 50; each uses the same amount of resources (time, space, etc.). Thus, sharing serves 50% of the total client population and should bear 50% of indirect costs. That percentage applies across all categories of indirect costs, from rent to utilities to salaries to depreciation.

Remember that you must be consistent in establishing what each category includes. If paid absences are part of salaries and wages in one report, for instance, they can't be part of a separate fringe-benefit line item in another report.

Reconciling differences

Expense reporting practices aren't standardized across programs, grantors, organizations or even funding agencies, which makes it more challenging to design yours. You may even have to get prior approval for your plan from funding sources or measure the same program expenses differently for different reports.

But once you establish your criteria and distribution bases, you should be able to create reports in whatever form they're required. And that's reassuring for regulators, donors, funding agencies, clients and, of course, your nonprofit. ✧

Term's up

Are term limits right for your board of directors?

Term limits for board members can be a double-edged sword: They can allow you to easily let go of unsuccessful board members, but they also can cause you to lose your most successful ones much sooner than you — or the member — would like. So before you implement term limits, consider how they could affect your board's effectiveness. And if you have such limits in place, be sure to periodically assess their impact.

Review the pros

On the one hand, term limits allow you to remove inactive or difficult members politely and, hopefully, without hurting their feelings in the process. Term limits can also create an opportunity for new board members with fresh ideas and perspectives to come onboard.

And they can provide flexibility as your organization grows and changes with the times. Suppose, for example, that a board member's term is expiring and a key initiative is to implement an advanced technology system. You may want to find a new board member with expertise in this area.

You may lose institutional knowledge and organizational history when founding and experienced members have to leave.

Term limits are also advantageous to board members. By knowing in advance that there is a time limiting their involvements, they can move on to other not-for-profits without feeling guilty for abandoning their posts. And they can exit gracefully when age or life-changing situations are affecting their participation.

Consider the cons

Alternatively, some nonprofit boards believe that term limits can do more harm than good. First, your organization could have to look for qualified and dedicated volunteers every couple of years. Recruiting board members can be difficult and time consuming, leaving the board less able to focus on its primary responsibilities.

Next, term limits require your board and organization to commit to an endless cycle of new member training. This can diminish your board's return on its training investment — by the time a member becomes a valuable asset and is an effective member, his or her term may be up.

Also, you'll sacrifice your most dedicated and productive members when their terms are over. Although ideally all board members would contribute significantly and equally, not-for-profits often have a few members that they rely on to do the bulk of the board's work. Losing one of these key members can be devastating.

Last, you may lose institutional knowledge and organizational history when founding and experienced members have to leave. If the longest-serving board member has just four or five years' experience, the board may have no recollection or understanding of why a particular decision was made or for what reason an action was carried out.

The effects of high board member turnover can be felt throughout your organization. It can disrupt program continuity and call for your executive director to constantly adjust to new board priorities and leadership styles.

Protect your organization

Term limits may alleviate an immediate problem, such as a difficult board member. But incorporating them to remedy today's problems could lead to bigger ones in the future.

Consider a midsize nonprofit whose board instituted term limits several years ago as part of a strategy to remove an ineffective member. Now, one of its best members, who has been critical to a major transition within the organization, is facing the end of her term. The board doesn't want to lose her — particularly not in the middle of this important change — and she doesn't want to leave.

Fortunately for the organization, the board can vote to temporarily suspend the term limit bylaw to allow the member to continue her service through the end of the transition. But under the bylaws, unanimous approval is required for the suspension, so if the board can't unanimously agree, the term limits will be a detriment to the not-for-profit.

Consider other options

If term limits aren't appropriate for your organization, there are alternatives. You can:

- Develop an advisory committee to evaluate board members and assess their ongoing interest and compatibility with other members,
- Conduct board self-assessments to find those members who may not feel that they're able to participate adequately, or
- Interview potential board members (or existing members wishing to continue their service) to determine their level of commitment and awareness of your organization's issues — and offer positions only to those who express solutions and describe how they can significantly contribute.

Some organizations rely on "natural" turnover, such as member relocations, retirements or changes in interest.

Weigh the facts

Because every nonprofit has its own culture and unique set of circumstances, there is no easy answer to whether to incorporate board member term limits into your organization's bylaws. To determine what's best for your not-for-profit, weigh the pros and cons of each option and think about your organization's current and long-term health. ✧

Assessing your D&O insurance needs

One of the most difficult questions for many nonprofits to answer is whether they should have Directors and Officers (D&O) liability policies as part of their insurance coverage.

The answer is … maybe. General liability coverage protects your organization in lawsuits stemming from incidents such as a client falling down the stairs, but it won't protect your directors in lawsuits alleging discrimination or sexual harassment.

Directors and board members are responsible for their decisions regarding the governance and management of an organization. If you don't have D&O coverage, they're also responsible for paying to defend themselves against allegations that their decisions caused harm to employees, volunteers or clients.

In some states, volunteer immunity statutes provide limited protection for simple negligence, but those laws won't help with federal liabilities, such as violations under the Americans with Disabilities Act, or protect everyone associated with your nonprofit. However, your not-for-profit may be covered by another organization. So be sure to find out if you have this insurance, and be sure it covers the necessary individuals.

D&O insurance varies widely in scope of coverage and cost. Keep in mind that some policies use exclusions to limit seemingly broad coverage. If a policy excludes sexual abuse claims, for example, it may also exclude sexual harassment claims by defining sexual harassment as sexual abuse.

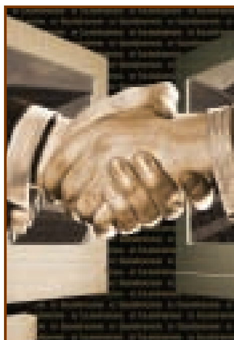
Ensure your policy covers allegations of wrongful employment acts. According to the Alliance for Nonprofit Management, they are the No. 1 source of D&O claims against nonprofits.

As with most insurance coverage, D&O policy premiums are likely to be lower if you opt for higher deductibles. You should, however, be sure that yours requires the insurer to pay litigation costs as you incur them. Otherwise, you may find yourself forced to shell out significant sums and wait to get reimbursed.

D&O insurance can protect your directors — and, increasingly, your not-for-profit — but finding the policy that's best for your situation is not an easy task. Consult your financial, legal and insurance advisors before you find your organization paying premiums and damages.

Newsbits

Online giving on the up and up



Network for Good, a processor of online charitable donations for more than 1 million nonprofits, released a report, *The Young and the Generous*, analyzing the $100 million donated to 20,000 groups through its site and affiliated sites since November 2001.

The report found that online giving has grown in recent years, and that online donors are younger and more generous than traditional givers. The median age of online donors is 38, compared to offline donors, who tend to be over age 60. It also reveals that people giving online through Network for Good give more than traditional donors: Their online gifts averaged $137 in 2005, compared to $27, the average gift for nonprofits overall.

More than half of those donors are female, and virtually all of them have given to a charity before. Also, smaller organizations benefit more from online giving. Half of the donations made through Network for Good benefit midsize and large charities, with the other half going to small and midsize organizations. When you exclude humanitarian causes, such as the American Red Cross and Salvation Army, about 70% of donations go to small and midsize organizations. ✧

Nonprofit Congress' top 3 priorities

The Nonprofit Congress, an initiative of the National Council of Nonprofit Associations, brought together nearly 400 leaders from not-for-profits in 47 states for a national meeting in October. There they voted on what priorities should be part of the Nonprofit Congress' strategic plan to unify not-for-profits and strengthen the charitable sector. The organization's top three priorities are:

1. Nonprofit organizational effectiveness, with a focus on accountability and leadership,
2. Advocacy and grassroots community activities, and
3. Public awareness and support of the nonprofit sector.

To help achieve its three goals, the Nonprofit Congress is focusing on enhancing collaborative and cooperative efforts within the sector, developing more effective partnerships with the government and businesses, and effecting social change. ✧

Go figures: The steady climb of nonprofit revenues

The revenues of nonprofits increased 61.5% from 1994 to 2004, according to a report from the Urban Institute's National Center for Charitable Statistics in Washington, D.C.

The Nonprofit Sector in Brief: Facts and Figures from the Nonprofit Almanac 2007 provides a synopsis of the 1.4 million public charities and other not-for-profits registered with the IRS. In 2004, these groups reported $1.36 trillion in revenue, $1.26 trillion in expenses, and $2.97 trillion in assets.

The report noted that hospitals and other health care organizations — 12.9% of all reporting public charities — accounted for 58.7% of the sector's revenues, 41.1% of its assets and 60% of its expenses in 2004.

Colleges and other higher education nonprofits — less than 1% of reporting public charities — accounted for 11.6% of the sector's revenues, 22.3% of its assets and 10.9% of its expenses. Human service organizations — 34.5% of reporting public charities — accounted for only 13.6% of the sector's revenues, 11.5% of its assets and 14% of its expenses. ✧

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Link, Murrel & Company

Helping nonprofits fulfill their missions

As a nonprofit executive, you know that operating your organization successfully today is a challenge, to say the least.

You not only have to deal with more intense competition for limited support, you also have to use your resources as efficiently as possible to stay in the black. And of course you have to make sure your organization complies with increasingly complex reporting requirements and regulations — and achieve your goals, too.

This is where Link, Murrel & Company can help. We specialize in helping nonprofits with a full range of accounting, audit, tax, consulting and compliance services.

Our nonprofit clients include a wide range of organizations in the greater Orange County area. Our emphasis on developing proactive, personal and value-added relationships with our clients has helped us build a strong reputation for quality, reliability and performance that exceeds expectations.

Link, Murrel & Company is a proud sponsor of the Volunteer Center of Orange County and supports their mission of being an "essential partner in improving the quality of life in Orange County by connecting community resources, increasing volunteerism, and building professional capacity in nonprofit organizations." The Volunteer Center of Orange County strives to encourage people to become personally involved in making the community a good and welcoming place to live, work, and raise a family. They have developed ways for people to best use their valuable time and talents to help others.

The Volunteer Center of Orange County recently hosted the Inaugural Conference of the Center for Social Enterprise, which provided nonprofit executives, board members and social investors with information about the concept of social enterprises and attempted to increase their awareness and willingness to consider social enterprise strategies for sustainability. The Volunteer Center is dedicated to helping nonprofit organizations generate earned income in support of each organization's mission.

Please visit their website at www.volunteercenter.org.

We hope you enjoy this issue of Profitable Solutions for Nonprofits and that it provides you useful information. Recommendations contained in this newsletter may not be appropriate in certain situations. Before implementing any of the ideas suggested, please contact our office for further inquiry.

We invite you to call Wm. Gary Crouch at (949) 261-1120 to answer any questions you might have about various nonprofit issues or to discuss how we can help your organization meet the challenges facing not-for-profit organizations today.

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