Streetsmart

Financial Basics FOR Nonprofit Managers

FOURTH EDITION

THOMAS A. McLAUGHLIN

WILEY

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To Gail, Paul, and Emily

Contents

Preface

Over the past three decades, the nonprofit sector has grown at an astonishing pace. Today, there are more than 1.1 million nonprofit public charities and about 380,000 other types of nonprofit entities. The sector is beginning to figure prominently in public conversations as an acknowledged source of innovation and solutions to various social issues, especially in areas where government at all levels was formerly more active. This trend seems likely to continue and even accelerate in the years to come.

With greater prominence and more widespread acceptance come greater attention and more scrutiny. Nonprofit management is becoming a recognized specialty, and there is a growing recognition that nonprofit financial management is not just for-profit financial management with a different name. The number of individuals and entities specializing in nonprofit financial management is growing as well.

With this growth in numbers comes a comparable growth in the demand for sophisticated management. The problem is that few nonprofit managers have any formal training in financial management. Almost everything they know is from on-the-job training, with a liberal amount of assumptions and conventional wisdom that may or may not be helpful. In some cases, these managers can rely on native instinct and clarity of thought, but most often they simply wing it and hope for the best.

Nonprofit organizations—and the users and funders of their services—deserve better, and they are getting it. It is not much of a stretch to say that the increased emphasis on financial management in nonprofits reflects a laudable striving for greater accountability. No longer is it enough just for one's financial records to be in order; one must be able to demonstrate

good financial systems in order to meet all the other rising demands on today's nonprofit.

In my work as a nonprofit management consultant and nonprofit board member, I continue to find a widespread hunger for practical, immediately helpful financial information. That was the initial stimulus for this book, and it remains so today.

In this volume, I tend to steer away from technical compliance-related matters, for two reasons. First, others can cover financial compliance subjects better than I. And, second, my vision of financial management goes far beyond simple compliance to a stage that I fervently hope will be characterized by thoughtful, creative, and persistent management actions.

To support those who share my vision, I have tried to make this book as practical as possible. For example, most of my financial calculations and many examples are based on the IRS Form 990, the nonprofit tax return. By using the only common financial reporting form, I hope to bridge the gaps between different types of nonprofit organizations so that the content will work equally well for a broad audience.

In recent years, I have seen a growing interest in the American nonprofit sector by people from other countries. From conversations with my consulting and academic colleagues, I know I am not alone. Foreign students and managers face the double challenge of learning financial concepts while also familiarizing themselves with cultural matters that are uniquely American. This is why I added an appendix again in this version that is designed to be a kind of cultural primer on practices, institutions, and policies that most Americans take for granted but that would be stumbling blocks to non-Americans' understanding.

As with the first edition, this book is not intended to be primarily a textbook. There are hundreds of thousands of people involved with nonprofits who need to know about financial management but who don't need another textbook in their lives. It is to them that I speak through these pages. At the same time, I have been flattered that many professors and academic programs throughout the country have adopted the book for use in the classroom, and I thank them. I can only hope that their students do, too.

As a rookie executive director many years ago, I never dreamed that I might one day write a book that so many would find useful. Mainly, I was consumed with trying to figure out what seemed like a gargantuan task

rapidly enough to avoid appearing foolish. In some very real ways, this book is a record of my personal journey through a sometimes confusing topic. The existence of this fourth edition is pleasing validation that many people have found my approach to nonprofit financial management helpful. I hope only that that will continue to be the case.

—Tom McLaughlin
November 2015

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Note to Reader

Throughout this book, a web icon indicates that you should go to the accompanying website for corresponding templates or examples. The website address is www.wiley.com/go/basics4E. Refer to Appendix C, "Using the Website," for the table of contents and detailed instructions for use of these templates.

Streetsmart Financial Basics

FOR

Nonprofit Managers

PART ONE

Analysis

CHAPTER 1

Structure of Nonprofit Organizations

Corporations

One of the distinguishing features of our legal and financial systems is that they have found a way to make something that no one can see or touch seem real—and therefore, it has become *real*. The high point of this accomplishment is that perfectly intelligent, normal people can find themselves debating the virtues of the behavior of this thing and even changing their own behaviors and choices because of its existence.

We are talking, of course, about the corporation. Even the word itself sounds substantial, and when various names or other identifiers get put in front of it, we accept the results easily. But the idea of a corporation is nothing more than a construct that gains substance and credibility in financial matters largely because we need it to do so. Our acceptance of the metaphor of a corporate *structure* is tangible evidence that we human beings yearn for predictability and consistency even when the entity itself exists only in our minds and in the ways that a corporate structure is said to *behave*.

We say all this because whatever corporate structures lack in tangible qualities they more than make up for via their widely accepted ways of indicating financial boundaries. As you will see later in this book, those boundaries can take on the nearly concrete feel of something that can seem to be virtually a physical presence.

The highest level of nonprofit management is the corporation that "owns" or runs the programs. The corporation is a statutory entity

established by the legally sanctioned actions of one or more individuals. As a legally approved entity separate from its constituent individuals, the corporation has its own continuing existence. In legal theory, corporations are treated as distinct entities like individual people, and corporations have their own collection of responsibilities, liabilities, and powers.

Why a corporation? The answer is disarmingly simple: because it's easier for the rest of us. Corporations can be mentioned in the same legal breath as the individuals who use their services, work in them, or simply exist in the same state with them. All are on the same legal footing, in that respect. The complicated and narrower answer to the question has to do with a variety of practical considerations. For instance, revenue source regulations and political realities often nudge nonprofits in the direction of a specific type of organizational structure. Programs such as battered women's shelters almost of necessity start out as single-service corporations, while older and more established groups may have developed a multicorporate structure.

There are also liability laws to consider when operating different types of businesses. Nonprofit public charities traditionally have been granted generous protection from state liability laws, although that tendency is beginning to change. It's a tradition growing out of English common law that has been codified in many places around the country. Often there will be either an explicit limitation on suits or a prohibition altogether on the grounds that entities funded by the public at large ought not to be siphoning resources into private hands via lawsuits. Liability considerations alone are not normally strong enough to determine a corporate structure, but the more favorable liability climate for public charities is clear.

Like most for-profit businesses, nonprofit organizations must have a legally acceptable structure within which to operate. Nonprofit public charities are officially considered 501(c)(3) corporations. There are literally dozens of other structural choices in the IRS list of tax-exempt entity types, but this one is easily the best known. The official IRS list of these choices is reproduced in Exhibit 1.1 from IRS Publication 577.

This bloodless list of unsentimental choices obscures a central point. Corporate structures in the nonprofit world are chosen for many reasons, the primary ones being risk management, tax treatment, and the best available corporate fit for carrying out missions. The same kind of reasoning

about structural choice takes place in for-profit entities. With such a large number of potential structural options, entrepreneurs—in the nonprofit sector or outside of it—would do well to mimic the guiding principle of good architecture: *form follows function*. Put simply, be as clear as one can possibly be in determining what one wishes to accomplish *and then* give some serious thought to the best structural choice available.

This area of structural choice for public-serving entities has seen unprecedented innovation recently. One of the most intriguing developments in the nonprofit sector has been the rise of alternative structural choices, such as low-profit limited liability companies (L3Cs) and benefit corporations (more about these and other choices will follow).

DROPPING OUT OF SCHOOL

The community center prided itself on being able to identify community needs and respond to them effectively over time. Unfortunately, their grand, old 175,000-square-foot building had already chewed up substantial funding just to keep it running. They achieved their first operating surplus in years, but it was a tissue-thin $7,900 on a budget of $10 million. Projections for next year contemplated more red ink.

The most prominent program in their building was their Montessori school, which occupied only about 7 percent of their total space but represented half of their total employees. Moreover, it was running a regular six-figure deficit. As part of a strategic positioning process, the question arose: Why are we doing this?

There was not an obvious answer. When a financial commitment of this size does not have a ready answer to this simple question, it is usually time for some rethinking, which is what the center did. As a result, the school was spun off as its own nonprofit public charity, with parents and teachers taking over the management. The happy ending is that the school now rents its space from the community center and is a steady source of earned income.

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Ultimately, corporate structures are simply a way to organize programs and services in logical ways to achieve maximum results. What the community center realized was that a Montessori school, while important to the community, was too much of a mission stretch for them. Recasting the legal structures allowed the center to focus on the programs and services it was good at, while turning a management diversion into a source of revenue.

Programs

Programs are the most visible and best understood aspect of the nonprofit form of business organization and its chief means of carrying out its mission. Also called services, projects, clinics, divisions, departments, floors, or any one of a thousand other names, programs are the activities of the nonprofit organization.

Coming up with a fair and workable definition of a program is difficult. Here's an attempt: A program is a coherently packaged group of activities, usually associated with one or more specific locations, designed to accomplish a stated result.

Nonprofit organizations run all kinds of programs and often more than one. Day care centers offer infant care programs, environmental groups operate recycling systems, museums run art appreciation courses, and so forth. The two keys to understanding programs are that they generally have some coherent internal structure, and they appear as distinct choices to potential users.

In most nonprofit organizations, programs are like little businesses, with a structure reinforced by nonprofit accounting rules and with immense if largely unnoticed consequences for everything from compensation to organizational effectiveness. They represent a delegation of responsibility from the CEO, and so they are the engines of mission. It is at the program level that the organization's goals are accomplished or not; therefore, those in charge of programs carry heavy moral pressure to get the job done.

Notice the use of the word "moral" in the preceding sentence. Typically, the motivations of those who run nonprofit organizations are different