Profitable Solutions for Nonprofits

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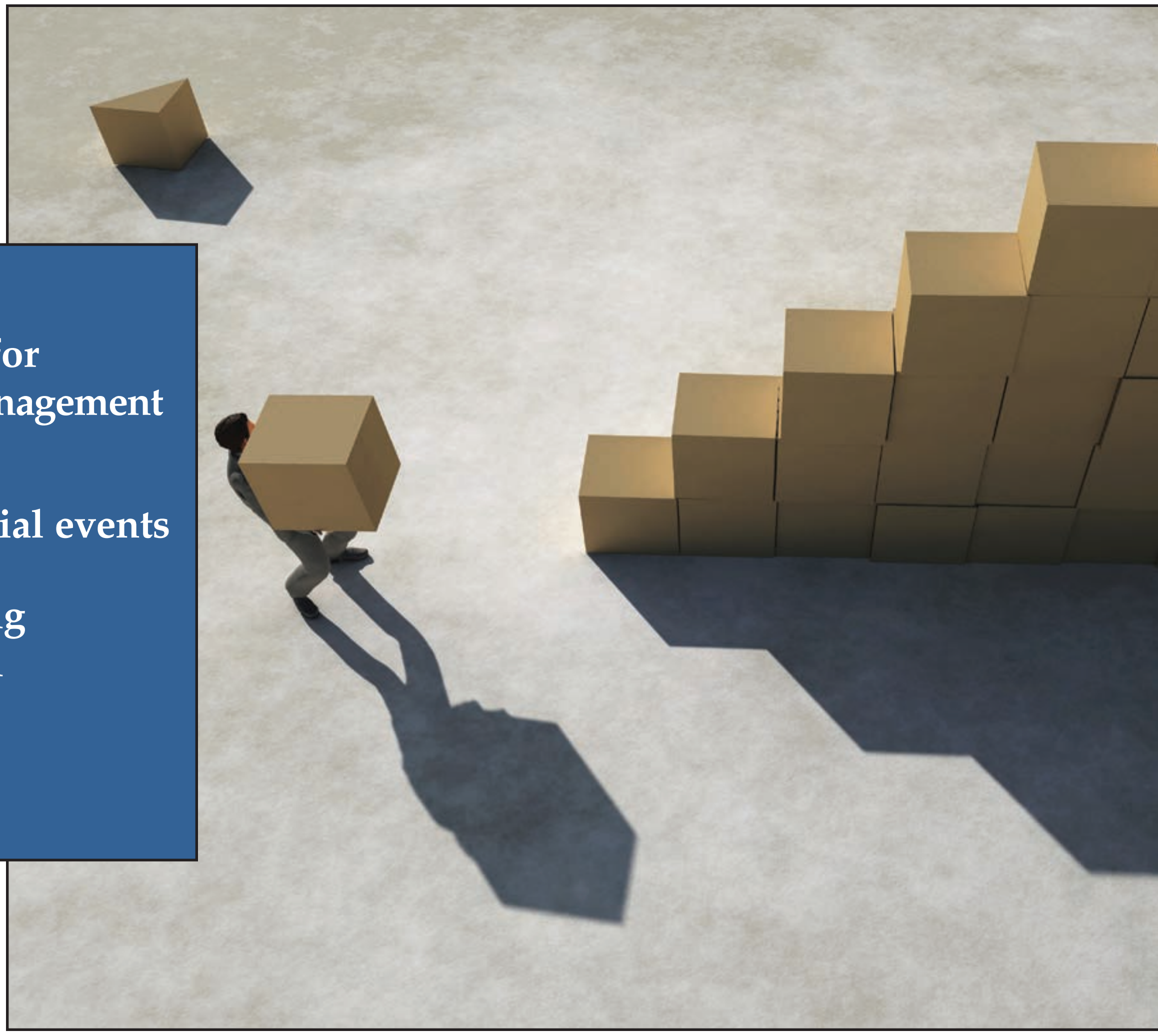

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Building a foundation for effective endowment management

Overseeing a nonprofit's endowment fund is one of the most important roles for the board of directors. A strong investment committee, made up of board members and staff, will not only ensure the continued health of the endowment and the organization but also attract other donors looking for good stewards for their contributions. Effective endowment management lies in the following building blocks.

INVESTMENT POLICY

Every endowment should have a comprehensive investment policy that drives the management of the fund. According to the Uniform Prudent Management of Institutional Funds Act (UPMIFA), investment decisions must be made in relation to the nonprofit's overall resources and purposes. And the endowment investment policy should be different from the policy for other investments of the organization.

"Prudent" investment decisions must consider the entire portfolio and be made as part of an investment strategy with risk and return objectives reasonably suited to the fund and the organization. UPMIFA also permits "only investment costs that are appropriate and reasonable." (UPMIFA applies only to "true" endowments funded by donors, not "quasi" endowments created by boards.)

The investment policy can change over time as objectives or other factors change.

The endowment's objectives should guide its investments and management. For this reason, it's important not to simply adopt a generic objective but to articulate an objective that reflects the organization's own circumstances. For many not-for-profits, the primary goal is to preserve and grow funds for the organization's long-term stability while providing a predictable contribution to support current activities. As a living document, the investment policy can change over time as objectives or other factors change.

ASSET ALLOCATION

The investment policy will include an optimal asset allocation. The investment committee must analyze the risk and return of potential investments (including stocks, bonds and alternative investments such as hedge funds and private equity) to determine the best mix and to obtain the total desired return. To maintain flexibility for responding to changes in the investment environment, it's best to establish ranges for each asset class instead of set percentages.

On a quarterly basis, the investment committee should review information on the performance of each asset class. Allocations can then be adjusted based on both performance and any change in circumstances.

SPENDING POLICY

The investment policy should include a *spending* policy for the endowment, setting a percentage that can be spent annually. The spending policy will impact the performance of the fund, as well as its ability to fulfill the donor's intent.

UPMIFA sets standards for endowment fund spending. It provides that an organization can spend as much of a fund as it determines to be prudent for the "uses, benefits, purposes and duration" for which the fund is established. UPMIFA lists seven criteria to guide annual spending decisions:

1. Duration and preservation of the endowment,
2. The purposes of the organization and the fund,
3. General economic conditions,
4. Effects of inflation/deflation,
5. Expected total return from income and appreciation,
6. The organization's other resources, and
7. The organization's investment policy.

Unlike its predecessor, the Uniform Management of Institutional Funds Act, UPMIFA allows nonprofits to adopt a "total return" strategy that bases the spending rate on the endowment's total value (including appreciation) rather than on only income. To ensure reasonably consistent cash flows, many organizations using a total return spending policy apply "smoothing" mechanisms to minimize the effect of market volatility. An organization might, for example, use a three- or five-year rolling average calculation.

PERFORMANCE MONITORING

The investment policy should include benchmarks for evaluating the performance of investments and managers, too. Performance should be assessed over both full market cycles (seven to 10 years) and the shorter time periods that compose them.

An internal investment committee can meet quarterly to review performance, consider recommendations for changes to the investment strategy and rebalance asset allocation as necessary.

HELP IS AVAILABLE

Endowment management can seem overwhelming, especially for volunteer board members with many other demands vying for their time. Your financial advisor can help with many of the critical decisions, including asset allocation, vetting of fund managers and financial reporting compliance. (See "Don't forget the disclosure requirements" below.) ❃

DON'T FORGET THE DISCLOSURE REQUIREMENTS

Keep in mind that every endowment — whether or not it's covered by the Uniform Prudent Management of Institutional Funds Act (see main article) — must make the following financial statement disclosures under Generally Accepted Accounting Principles (GAAP):

- A description of the governing board's interpretation of the law(s) underlying the organization's net asset classification of donor-restricted funds,
- A description of the organization's endowment spending policy(ies),
- A description of the organization's endowment investment policy(ies),
- The composition of the endowment by net asset class at the end of the period, in total and by type of endowment fund, with donor-restricted funds shown separately from board-designated endowment funds,
- A reconciliation of beginning and ending endowments, in total and by net asset class,
- The nature and types of permanent or temporary restrictions on the endowment net assets, and
- The aggregate amount of the deficiencies for all donor-restricted endowment funds where the fair value of the assets at the reporting date is less than the level required by donor stipulations or law.

The bottom line

How to account for special events

More and more nonprofits are turning to special events as a major source for generating funds. As if event planning isn't complicated enough, organizations also must take care to properly present the associated revenues and costs in their financial reporting.

BEYOND "FUNDRAISING"

When you sponsor an auction, golf outing or "fun run," the main goal is usually to raise funds. So it's easy to understand why some nonprofits mistakenly treat all of the revenues and costs as they would for other fundraising-related activities. But — and here's the important part — certain amounts related to special events must be reported on financial statements in categories other than fundraising.

The amount charged to attend an event usually exceeds the cost of donor benefits, with the excess considered a contribution. Donor benefits are considered "exchange transactions" where a donor receives something (for example, a dinner or T-shirt) for the donation. These may be reported in a separate supporting category, such as cost of sales, or as a program-related expense, although there are several allowable options.

REPORTING GROSS REVENUES AND COST OF DIRECT BENEFITS

Nonprofits have three options for reporting most special events on their Statement of Activities:

1. Present the cost of direct benefits to donors as a line item deducted from the special event gross revenues in the revenue section,
2. Include the cost of direct benefits to donors in other program or supporting service expense and present the gross revenues in the revenue section, or
3. Present the exchange portion as special event revenue (for the fair value of the benefit the donor received) and the remainder of the revenue as contribution revenue. The cost of the direct benefit to the donor is deducted from the exchange portion.

These options apply to special events that are ongoing and major activities for the organization.

If the event is a one-time or incidental activity, amounts can be reported as gross (meaning revenues and expenses are reported separately, as in the options above) or net (expenses are netted against revenue and presented as a single amount) on the Statement of Activities.

TRACKING TRANSACTIONS

Proper financial reporting will require careful tracking of a special event's transactions. For revenues, you'll need to track the number of tickets sold, the price paid for tickets and the fair value as well as cost of the donor benefit.

For example, if 100 attendees paid $200 for a dinner with a fair value of $50, the contribution revenue is $15,000 ([$200 - $50] × 100 tickets). The exchange portion is $5,000 ($50 × 100 tickets).

You'll also need to track the cost of the dinner. Say the dinner cost the organization $35 per person. The cost of direct benefits to donors is $3,500 ($35 × 100). Note that the total cost of direct benefits to donors will typically include more than just the cost of the dinner — it would include costs for facility rental, decorations and the like.

Other costs could be reported as fundraising expenses. Expenses incurred for marketing the event, public relations, allocated employee time and similar costs qualify as fundraising.

AND TAX REPORTING, TOO

Special events come with special tax reporting and compliance requirements, particularly if gaming is part of your event. Your financial advisor can help you satisfy all of the reporting requirements so you can focus on putting on the best — and most lucrative — event possible. ❋

Look before determining executive compensation

When your nonprofit sets the salary for an executive director or other individual key to the organization, the board of directors wants to make sure it's paying what's necessary to attract or retain the most qualified, capable individual for the position. But that's not the only consideration that should be on the radar screen.

"EXCESS BENEFITS" AND "DISQUALIFIED PERSONS"

Internal Revenue Code Section 4958 prohibits 501(c)(3) and 501(c)(4) organizations from engaging in an "excess benefit transaction" with a "disqualified person." Disqualified persons generally include anyone in a position to exercise substantial influence over the organization's affairs at any time in the five-year period before the transaction, including officers and directors.

An excess benefit transaction takes place when a disqualified person receives a benefit that exceeds the value the organization receives in exchange — for example, when an executive director is paid a salary that far exceeds the salary of executive directors at similar organizations. Violations of Sec. 4958 can lead the IRS to impose excise taxes (intermediate sanctions) on the disqualified person who benefited from the transaction as well as the not-for-profit's leaders (for example, board members) who approved it.

WHEN IS COMPENSATION "REASONABLE"?

Federal tax regulations provide a "rebuttable presumption of reasonableness" for compensation arrangements that satisfy three requirements. If you have met the following requirements, it will be up to the IRS to prove otherwise.

First, an authorized body of the nonprofit — typically the board of directors or a subcommittee composed of board members — must approve the salary and benefits before the compensation package is offered to the candidate or employee. It's critical that none of the participants have a conflict of interest regarding the arrangement. For example, if the individual is already a staff member, neither the individual nor a subordinate of the individual can participate in the compensation decision.

Second, the authorized body must rely on appropriate comparability data before it determines compensation. It can rely on data derived from industry surveys, documented compensation of individuals in similar positions in similar organizations, expert compensation studies or other data about reasonable compensation for the position. If your organization's gross annual receipts are less than $1 million, you will need compensation data for three similar positions in similar communities. The regulations don't specify the requisite number of comparables for larger organizations.

Remember that similar job titles don't necessarily mean similar jobs. When evaluating comparability data, the positions must have comparable *duties*, not just titles.

Last, the authorized body must adequately document the basis for its determination *while* making that determination, such as in the meeting minutes. This requirement is often overlooked. Documentation must include terms of the arrangement and the date it was approved, members of the body who were present during debate and those who voted on it, comparability data that was relied on and how it was obtained, and any actions by a member with a conflict of interest.

You must prepare the documentation before the later of the next meeting of the authorized body or 60 days after the body's final vote on the compensation. The body also must approve the documentation within a reasonable time after preparation.

WHEN IS THERE A CONFLICT OF INTEREST?

Conflicts of interest must be avoided during the compensation-setting process. A member of the authorized body charged with approving a compensation arrangement has a conflict of interest if he or she fits *any* of several criteria.

When evaluating job comparability data, the positions must have comparable duties, *not just titles.*

For example, a member can't be a disqualified person participating in or economically benefiting from the compensation arrangement or a family member of any such disqualified person. Nor can a member be in an employment relationship subject to the direction or control of any disqualified person participating in or economically benefiting from the compensation arrangement. Consult with your CPA regarding all of the criteria.

PLAYING BY THE RULES

Determining an executive's compensation package can be tricky. It's easy for subjective considerations to come into play. Consult your CPA advisor during the compensation-setting process to make sure that your nonprofit is playing by the rules. ❋

Newsbits

ONLINE GIVING JUMPED 14% IN 2013

A study from Nonprofit Technology Network and M+R Strategic Services found that donors made more online contributions to U.S. nonprofits in 2013 than ever before, with more than 5.5 million total gifts and nearly $325 million raised. Online revenues and online gifts increased by 14% last year. The average revenue per 1,000 fundraising messages delivered was $17, or 1.7 cents per message. Monthly giving accounted for 16% of all online revenue in 2013.

With so many donations flowing through the Internet, it's critical that nonprofits implement appropriate controls to secure contributions and protect donor information. ❃

STUDIES HIGHLIGHT HEADACHES OF WORKING WITH GOVERNMENT

Studies released concurrently by the Urban Institute and the National Council of Nonprofits shed light on some of the problems experienced by nonprofits that receive government funding. The Council's report provides real-world context to the problems identified through nationwide statistical data collected by the organizations in a joint survey.

For example, 72% of nonprofits surveyed said the government-reporting process was time-consuming and complex, and 45% had problems with late payments. Other problems include governments not paying the full costs of providing services and changing contract terms midstream. ❃

STATES EXPERIMENT WITH PAY FOR PERFORMANCE

Illinois is following the lead of New York and a handful of other states in testing the waters of Pay for Performance (PFP) contracts with social services nonprofits. According to *Crain's Chicago Business*, a coalition of Chicago-area foster care agencies and other providers of youth services will participate in the state's first effort to pay for successful outcomes, rather than specific services. Private investors will fund the upfront costs of the program and receive a modest return on their investment from the savings the program is expected to achieve by, for example, reducing the number of youths who land in group homes or juvenile detention centers. ❃

SILICON VALLEY LAUNCHES NEW NONPROFIT MODEL

The Silicon Valley "accelerator" Y Combinator is now leveraging its experience launching for-profit tech companies to help launch nonprofits involved in areas such as public health, microlending and education. Better known for launching for-profit companies like Dropbox and Airbnb, Y Combinator recently "graduated" its first class of nonprofits, including CodeNow, which teaches low-income kids how to write computer programming, and Noora Health, which offers health training to the family members of poor hospital patients in India. The *Washington Post* reports that the organizations will try to rely on their business models to survive, rather than on constant fundraising. The goal: Spend less on overhead and more on their core mission. ❃

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