

Streetsmart

Financial
Basics

F O R

Nonprofit
Managers

F O U R T H E D I T I O N

THOMAS A. McLAUGHLIN

WILEY

Streetsmart Financial Basics

F O R

Nonprofit Managers

F O U R T H E D I T I O N

THOMAS A. M^cLAUGHLIN

WILEY

This book is printed on acid-free paper. ∞

Copyright © 2016 by Thomas A. McLaughlin. All rights reserved.

Published by John Wiley & Sons, Inc., Hoboken, New Jersey.

Published simultaneously in Canada.

No part of this publication may be reproduced, stored in a retrieval system, or transmitted in any form or by any means, electronic, mechanical, photocopying, recording, scanning, or otherwise, except as permitted under Section 107 or 108 of the 1976 United States Copyright Act, without either the prior written permission of the Publisher, or authorization through payment of the appropriate per-copy fee to the Copyright Clearance Center, 222 Rosewood Drive, Danvers, MA 01923, (978) 750-8400, fax (978) 646-8600, or on the web at www.copyright.com. Requests to the Publisher for permission should be addressed to the Permissions Department, John Wiley & Sons, Inc., 111 River Street, Hoboken, NJ 07030, (201) 748-6011, fax (201) 748-6008, or online at www.wiley.com/go/permissions.

Limit of Liability/Disclaimer of Warranty: While the publisher and author have used their best efforts in preparing this book, they make no representations or warranties with respect to the accuracy or completeness of the contents of this book and specifically disclaim any implied warranties of merchantability or fitness for a particular purpose. No warranty may be created or extended by sales representatives or written sales materials. The advice and strategies contained herein may not be suitable for your situation. You should consult with a professional where appropriate. Neither the publisher nor the author shall be liable for damages arising herefrom.

For general information about our other products and services, please contact our Customer Care Department within the United States at (800) 762-2974, outside the United States at (317) 572-3993 or fax (317) 572-4002.

Wiley publishes in a variety of print and electronic formats and by print-on-demand. Some material included with standard print versions of this book may not be included in e-books or in print-on-demand. If this book refers to media such as a CD or DVD that is not included in the version you purchased, you may download this material at <http://booksupport.wiley.com>. For more information about Wiley products, visit www.wiley.com.

Library of Congress Cataloging-in-Publication Data:

McLaughlin, Thomas A.

Streetsmart financial basics for nonprofit managers / Thomas A.

McLaughlin.

Fourth Edition. | Hoboken : Wiley, 2016. | Revised edition of the author's Streetsmart financial basics for nonprofit managers, 2009. | Includes index.

LCCN 2015042429 (print) | LCCN 2015047242 (ebook) | ISBN 9781119061151 (pbk.) | ISBN 9781119061274 (pdf) | ISBN 9781119061328 (epub)

LCSH: Nonprofit organizations—Finance. | Nonprofit organizations—Accounting.

Classification: LCC HG4027.65 .M35 2016 (print) | LCC HG4027.65 (ebook) | DDC 658.15—dc23

LC record available at <http://lccn.loc.gov/2015042429>

Cover Design: Wiley

Cover Illustration: Alexander Chernyakov /iStockphoto

Printed in the United States of America.

10 9 8 7 6 5 4 3 2 1

Streetsmart Financial Basics

F O R

Nonprofit Managers

To Gail, Paul, and Emily



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



Acknowledgments

Many people helped with one or more editions of this book. I particularly want to thank Allwyn Baptist, Becky J. Cerio, Robert Cowden, Dennis Fusco, Jim Gambon, Robert Gardiner, Catherine Gill, Elizabeth Hart, John Joyce, Laura Kenney, Bill Levis, Marty McLaughlin, Jim Mecone, Clara Miller, Wayne Moss, James Nesbitt, David Orlinoff, Mary Plant, Joanne Sunshower, Shari Sankner, and Sherrell M. Smith. Catherine Gill at the Nonprofit Finance Fund supplied some of the vignettes. My editors at John Wiley & Sons, Marla Bobowick, Susan McDermott, and Matt Gilbert provided support, feedback, and guidance in one or more editions.



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.



Contents

Preface	xiii
Acknowledgments	xvii
Note to Reader	xix
 PART ONE Analysis	 1
 CHAPTER 1 Structure of Nonprofit Organizations	 3
Corporations	3
Programs	6
Hybrid Corporations	8
Loss of Tax-Exempt Status: The Monster Within	14
 CHAPTER 2 Mission: Managing Your Two Bottom Lines	 17
The Role of a Value System	18
The Nonprofit's Dilemma and How to Solve It	20
 CHAPTER 3 Accounting as a Second Language: A Nine-Point Program	 23
The Entity Principle	23
Money Measurement	24
Conservatism Principle	24
The Cost Concept	26
The Materiality Principle	27
Going Concern	29
Dual Aspect	30
Realization Principle	32
Matching Principle	33
 CHAPTER 4 Assets Are for Boards, Activities Are for Managers	 35
Concepts Versus Details	36
Boards Invest, Managers Spend	37

	If It Has to Be Decided Today, It's Probably the Wrong Question	38
	Boards Own the Controls, Managers Implement Them	38
CHAPTER 5	Balance Sheets: How They Get That Way	39
	Current Assets (from IRS Form 990, page 11)	40
	Noncurrent Assets	43
	Current Liabilities	45
	Noncurrent Liabilities	45
	Making the Balance Sheet Dance	49
	Transparency, Thy Name Is IRS Form 990	52
	What to Do	53
CHAPTER 6	Financial Analysis: A Few Analytical Tools	67
	Financial Statement Analysis for Math Phobics	68
	Current Ratio	75
	Days' Cash	77
	Days' Receivables	79
	Cash Flow to Total Debt	81
	Debt to Net Assets	82
	Operating Margin	85
	Accounting Age of Plant/Equipment (or Land, Buildings, and Equipment)	86
	A Footnote	87
CHAPTER 7	Beyond the C3: Alternate Corporate Structures	89
	Commonly Available Structures	92
PART TWO	Accounting	95
CHAPTER 8	Nonprofit Accounting: Acknowledging the Strings Attached	97
	Net Asset Categories	98
	Other Provisions	99
	What It All Means	99
CHAPTER 9	Cost Accounting: How Much Does It Cost?	103
	A Form of Management Accounting	104
	Indirect Costs	106
	Certain Support Costs Get Assigned to Other Support Costs	106
	Breakeven Analysis—Another Use for Cost Data	110
	Cost Accounting versus Cost Reporting	113

CHAPTER 10	Auditing: Choosing and Using an Auditor	115
	Audit, Review, and Compilation	117
	The Auditor Market	119
	Getting Value from the Audit	122
	Conclusion	124
PART THREE	Operations	125
CHAPTER 11	Cash Is King	127
	Up the Balance Sheet	128
	How Much Cash Is Enough?	141
	Conclusion	145
CHAPTER 12	Capital: Not a Four-Letter Word	147
	Sources of Capital	148
	The Mechanics of Capital Financing	150
	The Present Value of Money	156
	The Great Divide among Nonprofits	157
	Future Access to Capital Markets	159
	The Role of Net Assets	161
	Strategic Capital Management	161
CHAPTER 13	Budgeting: Taming the Budget Beast	163
	Playing Revenues Like a Symphony	165
	Expenses	166
	Conclusion	176
CHAPTER 14	Indirect Costs and Other Despised Items	177
	Rules Govern Audits, Economics Rules Budgets	179
	Still, It's Low That Counts	182
	Secrets of the Indirect Cost Game	185
CHAPTER 15	Managing Money-Losing Programs	191
	The Origin of the Problem	192
	Solutions	192
	Other Sources of Value	192
	Ding Ding Ding Ding Ding!	194
CHAPTER 16	The Milestones of Spending on Overhead Costs	199
CHAPTER 17	Pricing: How Much <i>Should</i> It Cost?	205
	Pricing Methodologies	208
	Going the Other Way—Contractual Adjustments and Subsidies	212

	Pricing Strategies	213
	How to Price	214
CHAPTER 18	Profit: Why and How Much?	217
	Profit Defined	217
	Uses of Profit	218
	Profit—How to Get It	226
	What Can Be Done	228
CHAPTER 19	To Raise More Money, Think Cows	229
	Donations	230
	Bequests—Cow to Charity	230
	Charitable Remainder Trusts—Milk to Beneficiaries, Cow to Charity	230
	Pooled Income Funds—Donors Put Their Cows in a Herd, Keep Rights to Milk	233
CHAPTER 20	Owning a Building: What's in It for You?	235
	A Three-Part Calculation	236
CHAPTER 21	Insurance: The Maddeningly Complicated Art of Covering Your Assets	239
	To Insure or Self-Insure?	241
	Risk Management	242
	Captive Insurance Companies	245
	Quality Assurance in Disguise	246
CHAPTER 22	Internal Controls for External Goals	249
	The Elements of Internal Control	251
	How to Monitor the System	264
	Maintaining the System	266
	Conclusion	268
CHAPTER 23	Scrutiny Intensifies	269
	Some Predictions	272
	The Growing Industry of Charity Watching	274
CHAPTER 24	Management Controls: Toward Accountability for Performance	279
	Management Controls circa 1980	280
	Beyond Management Controls in the Twenty-First Century: How to Do It	281
	Messages	281

	How to Prepare—Changes in the CFO Role	283
	It's Called <i>Accounting</i> for a Reason	286
	Appreciate the Abrupt Change	287
	Frame the New Role	288
	Meet Your New CFO	288
PART FOUR	Planning, Control, and Miscellaneous	289
CHAPTER 25	Finance Is Oil, Development Is Water	291
	It's All about Time	291
	The Fix	293
CHAPTER 26	When Do You CFO?	295
	DIY	296
	The Financial Tasks Multiply	296
CHAPTER 27	Business Models and Business Plans	301
	First the Model, Then the Plan	302
	How to Build Your Business Model	304
	What, Exactly, Is a Business Plan?	305
	What Is in a Business Plan (Usually...)?	306
	Start-Up Nonprofits	306
	The Restructuring Nonprofit	307
	New Program or Division	308
	Goals Drive the Plan	309
CHAPTER 28	How to Beat the Next Recession	311
	Understand the Demand Pattern for Your Services	312
	Prepare for Reductions—in New Services	312
	Anticipate Foundation Behavior	313
	Proactively Communicate with Your Staff	314
	Consider Repurposing Your Reserves	315
	Stay Calm	315
Appendix A	A Financial Management Cultural Primer	317
Appendix B	Budget Bloopers	323
Appendix C	Using the Website: Table of Contents with Commentary	327
Index		333

Analysis
