

Financial Issues — FAQs

BoardSource has been answering governance-related questions posed by nonprofit leaders for more than 30 years. Here are our answers to some of the most frequently asked questions about financial issues.

Can a nonprofit organization have too much profit?

Nonprofit is a tax status and does not mean that nonprofits cannot generate revenue in excess of their expenses. Being financially successful is the dream of just about every nonprofit. An operational surplus allows you to do even more with less stress and equips your organization to undertake new activities to accomplish your mission.

If your organization creates an unexpected surplus, which cannot be used in operating expenses, you may wish to create an endowment, increase your rainy-day reserves, or provide services at a lower cost to clients.

What is private inurement?

Private inurement is prohibited in all nonprofits. It happens when a nonprofit's resources are used to provide a private financial benefit to someone in a position of leadership, often a member of the board or the chief executive or their family.

According to the IRS, a "section 501(c)(3) organization must not be organized or operated for the benefit of private interests, such as the creator or the creator's family, shareholders of the organization, other designated individuals, or persons controlled directly or indirectly by such private interests. No part of the net earnings of a section 501(c)(3) organization may inure to the benefit of any private shareholder or individual. A private shareholder or individual is a person having a personal and private interest in the activities of the organization."

An example may be paying your board members in a field where that is rare, such as community-serving charities, or over-paying members of your senior leadership team.

A nonprofit's revenue must be invested in the nonprofit's mission.

What is self-dealing?

Self-dealing is when a person in power uses that power to benefit themselves, their company, or their family. This may happen when a nonprofit organization does business with a board member. The board member is in a position of influence within the organization, and he or she may be seen as obtaining personal benefit from a financial relationship.

Any business relationship involving board members, their relatives, or their employers should be handled with care as it may be perceived as a conflict of interest. A clear conflict-of-interest policy includes a requirement for board members to annually disclose personal and professional affiliations. It also sets forth a process to follow when considering a business relationship with a board member.

Self-dealing in itself is not illegal for all nonprofits. However, private foundations are strictly forbidden to engage in such activities, no matter how insignificant the monetary benefit.

What are the key financial questions our board should ask? –

- Have we run a gain or loss? (i.e., Are we better or worse off financially than we were a year ago?)
- Are our key sources of income rising or falling? If they are falling, what are we doing?
- Are our key expenses, especially salary and benefits, aligned with similar organizations in our ecosystem and at our budget level?
- Do we have sufficient reserves? How do we know?
- Has the board adopted a formal policy for the establishment of reserves? Is our cash flow projected to be adequate?
- Are we regularly comparing our financial activity with what we have budgeted?
- Is our financial plan consistent with our strategic plan?
- Is our staff satisfied and productive? How do we know?
- Are we filing on a timely basis all the reporting documents we are required to file?

- Are we fulfilling all of our legal obligations?

What is an internal audit? —

In carrying out its oversight responsibilities, the board should regularly review the organization's policies and procedures on how it does business and manages its financial affairs. This task can be delegated to the audit or finance committee.

The committee should guarantee that an adequate internal control mechanism is in place to ensure that the organization is

- using generally accepted accounting methods
- complying with applicable laws and regulations
- providing reliable financial information
- minimizing risk
- operating effectively and efficiently

More specifically, an internal audit ensures that proper policies are in place to segregate financial duties, protect cash receipts, require second signatures on large checks, keep track of inventory, require an efficient bidding process, produce timely reports, and maintain accurate recordkeeping. Appropriate internal controls create a firm base for an effective outside financial audit.

What is the auditor's role in ensuring financial propriety? —

Why didn't the auditors catch it? That's the first question many people ask when confronted with a case of financial wrongdoing at a nonprofit organization.

Answering that question requires an understanding of the auditor's role. An auditor is an outside accountant engaged by the board of a nonprofit to review the financial statements prepared by the organization's staff. The auditor's main job is to judge the accuracy of the financial statements and report back to the board. To do this, auditors usually examine some typical transactions and review internal controls, accounting procedures, and financial reporting systems. Through the management letter, auditors also help nonprofits develop effective financial controls.

An audit is a spot check of information, not an exhaustive review of all financial transactions. Further, auditors are charged with determining the accuracy of the financial statements only "in all material respects." A clean bill of health from an auditor means that the auditor is convinced that the financial statements do not misrepresent the organization's financial position in any significant way; it does not guarantee 100 percent accuracy.

Auditors are not charged specifically with uncovering fraud. Since they rely heavily on management to provide information and documentation, small-scale fraud is extremely difficult for auditors to detect, particularly if it is being perpetuated by more than one key staff person within the organization.

An important final point: All firms are not equally qualified to audit a nonprofit organization. Nonprofits follow accounting conventions that are distinct from those of business and government. A firm that is unfamiliar with these guidelines or has little experience auditing nonprofits will be especially unlikely to uncover financial malfeasance.

What are the top ten questions you should ask your auditor to help prevent fraud? —

1. What internal controls are in place to prevent an employee, officer, or outside agent from intercepting checks intended for our organization prior to their being recorded on our books?

2. What controls are in place to prevent the unauthorized disbursement of funds from our bank accounts (general and payroll) by an employee or officer?
3. What controls are in place to prevent one of our vendors from overbilling our organization?
4. Are you aware of any forms of compensation or benefits received by our organization's officers, directors, or key employees that were not specifically approved by the board of directors?
5. Are you aware of any inappropriate or undisclosed relationships between officers, directors, key employees, vendors, or donors?
6. Are you aware of any relationships with vendors or contractors that appear to be less than ethical, warranting further inspection, or should otherwise be considered when putting out for competitive bid, (i.e., relationships that have become too casual or close)?
7. Are there any individuals involved in the accounting process who wield excessive control or whose work is not subject to adequate review by another individual?
8. How would you characterize the morale, work environment, and professionalism of accounting personnel and senior management of our organization?
9. Overall, how would you rate our organization in terms of how well we are protected against fraud?
10. What is the most important step we could take to further protect our organization against fraud?

What are intermediate sanctions? —

Traditionally, revocation of tax exemption was the IRS's only tool for punishing a nonprofit that exploited its status in some way. The revocation of tax exemption not only disciplined the organization but also penalized its customers and clients by discontinuing the services. Also, this disciplinary action lacked any built-in warning

mechanism or intermediate steps, which would allow the organization to correct its performance.

In 1996, the IRS installed intermediate sanctions, a system of excise taxes that are levied directly on the organization, as well as on those making the inappropriate decisions. Since then the IRS has expanded its focus on misconduct to include any type of financial transaction that benefits those in positions of influence within the organization.

How can a board protect itself from intermediate sanctions?—

The IRS's intermediate sanctions rules provide safe harbor mechanisms for directors serving on nonprofit boards when they determine compensation for the chief executive or engage in other financial transactions with a "disqualified person."

The safe harbor has three steps, and all of them must be satisfied:

1. Reliance on appropriate, objective comparability data (for organizations with revenue under \$1 million, the IRS recommends three data points; for organizations with revenue over \$1 million, five data points). Comparability data may come from the nonprofit or for-profit sector, when appropriate. The board may also rely on advice from independent experts, such as attorneys, CPAs, compensation consultants, and valuation experts.
2. Approval of the transaction by disinterested board members, with the interested person absent during debate and voting.
3. Adequate and contemporaneous documentation by the board of the basis for its decision in its corporate records.

What constitutes excessive compensation for chief executives?

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Excessive executive compensation receives a lot of attention. The real challenge many boards face is not how to reign in excessive compensation but rather how to find the resources to pay appropriate salaries.

Those who believe that the nonprofit sector has become too professionalized and “corporate” cite excessive compensation as an example of how many organizations are losing sight of their mission and their distinctiveness as nonprofits. Yet, the compensation of nonprofit executives usually lags behind the compensation of leaders in business and government.

Because revelations of inordinately high compensation can erode donor confidence and cause increased public skepticism, board members should pay close attention to compensation decisions. The compensation of board members, officers, and key employees of the organization is included on the IRS Form 990. The 990 is a public document that must be made available when requested by members of the public — including journalists. For this reason, compensation can’t be considered a private matter, and all board members should be aware of its implications.

To evaluate the appropriateness of executive compensation, consider

- the size and complexity of the nonprofit
- the mission area, geographic location, and financial condition of the organization
- the qualifications required for the job
- compensation at comparable organizations

A wrinkle exists to the challenge of determining appropriate compensation. The Intermediate Sanctions regulations enable the IRS to impose excise taxes and other penalties on nonprofit executives who are over-compensated. When determining appropriateness, the IRS evaluates whether the compensation was decided by an independent board, if appropriate comparable compensation data was obtained, and if the basis for determining compensation was documented. This power allows the IRS to penalize individuals receiving more compensation than their positions warrant, rather than resorting to revoke the tax-exempt status of the organizations.

What is Unrelated Business Income Tax (UBIT)?

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A major benefit of being a nonprofit is the exemption from federal and state income taxes. However, certain activities, considered unrelated to the organization's core mission, are subject to taxes. This tax is called Unrelated Business Income Tax (UBIT).

To be subject to UBIT, a profit-making activity must be regularly carried on, constitute a generally recognized trade or business, and be an activity that is not substantially related to the organization's tax-exempt status — meaning the activity does not further the mission of the organization.

Even though unrelated profit-making activities are permissible, they should not consume a significant portion of the nonprofit's resources. In extreme cases, the IRS may determine that the organization has abandoned its tax-exempt purposes and may seek to revoke its exempt status.

What level of reserve funds is appropriate for a nonprofit?

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Nonprofits — like businesses, families, and individuals — need to save for a rainy day. While few would dispute that assertion, disagreements sometimes arise over what level of reserves is appropriate. Often the level of reserves depends on the mission and type of organization. Nonprofit organizations created to run a specific event or those that do not intend to operate in the long-term may not be as concerned with developing reserve funds.

Those who argue for a very low level of reserves point out that an organization with a particularly imperative mission — the eradication of a disease, for example — has an ethical and moral obligation to use all its resources to carry out that mission as swiftly as possible. Others have questioned the ethics of an organization soliciting the public for donations while maintaining reserves that would allow it to operate for

many months, or even years, without any additional public support. Many of the national watchdog organizations have standards that specify the level of reserves they find acceptable.

Occasionally, people confuse the difference between reserves and money held in an endowment. The distinction is significant. An endowment is a pool of restricted money that is separately held, often in perpetuity or for a specific amount of time, with the dividends used to support the nonprofit. Reserve funds are more flexible. Reserves come from the accumulated surpluses of the organization over time and can usually be designated or allocated by the board. Reserves can be spent to expand programs and run the organization, while endowment usually can't. Many large institutions, such as universities and museums, have endowments that are many times their annual budgets.

What should our nonprofit investment policy include? —

Any organization that has assets to invest should have appropriate policies to guide these investments. One set of policies does not fit every organization; each organization needs to define its own goals and understand its own fiduciary responsibilities. Here is a list of the basic points to cover. Any investment policies should

- be developed with the advice of a financial professional or be reviewed by legal counsel
- define general objectives (preserve and protect the assets; achieve aggressive growth)
- delegate day-to-day asset management to an independent finance committee or a professional manager
- set asset allocation parameters (include diversification)

- describe asset quality (itemize quality ratings for stocks, bonds, or short-term reserves based on your risk tolerance)
- define the investment manager's accountability (include risk in transactions, social responsibility, reporting requirements, and coverage of cash flow needs)
- establish a system for regular review of the policies

How could we benefit from an endowment? —

Endowments can serve numerous purposes. Here are some ways your organization might benefit from an endowment.

- **Financial stability.**

A healthy endowment mitigates insecurity and eases financial pressures.

- **Regular income.**

Through smart investing an endowment provides reliable revenue for programs or overhead.

- **Emergency funds.**

An endowment serves as a safeguard against major disasters. However, it should not be considered as a tool to counterbalance bad financial management.

- **Future opportunities.**

An endowment — within the framework of spending policies — provides funding for new ventures or sudden opportunities.

- **Generational equity.**

An endowment allows an organization to meet the needs of future generations.

- **Donor opportunities.**

An endowment allows major donors to have a lasting impact.

- **Confidence builders.**

Funders are attracted to successful endeavors. A strong endowment builds donor confidence.

What should an endowment resolution include? —

After your board has decided to go ahead and create an endowment, it needs to formulate this decision into an endowment resolution. This resolution should address the following questions:

- What is the purpose of this endowment and how will it tie in with the mission of the organization?
- Who will manage the endowment? Will we have an independent investment committee or will we hire an outside manager? Will we consider other options, such as the local community foundation?
- What is going to be our investment strategy? How can we ensure that the separate and detailed investment policies remain in accordance with this strategy?
- What will our disbursement policy be? Will the board have the authority to transfer funds under special circumstances?

Other Topics to Consider:

[Board Dynamics and
Processes FAQs](#)

[Board Meetings FAQs](#)
[Fundraising FAQs](#)

[Board Responsibilities and
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