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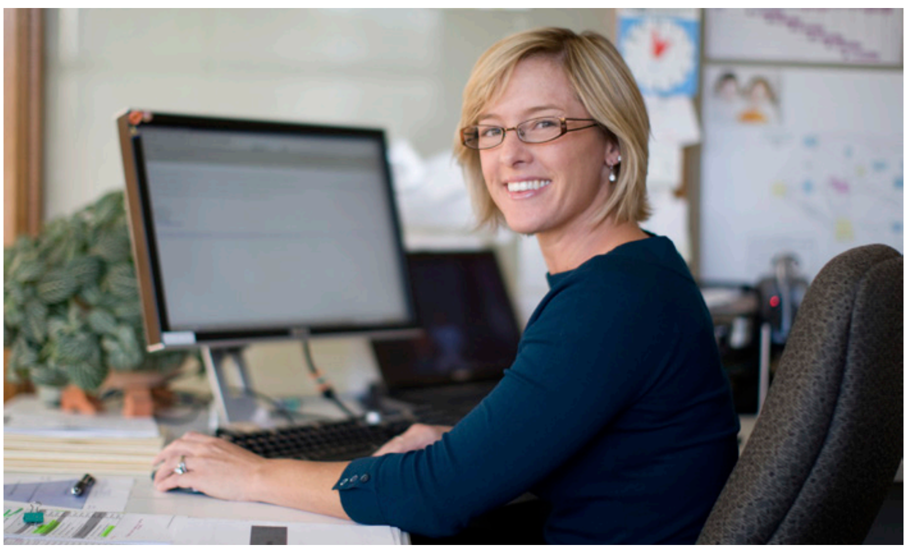

CHALLENGES FOR NONPROFITS IN 2017: FULFILLING MISSION GOALS WITH FLEXIBLE STRATEGIES

The change of administration in Washington, as well as state and local initiatives, makes this a hard time for nonprofit boards and management to predict and determine the best strategies for sustainability -meeting the needs of its stakeholders and financial viability becomes ever more challenging.

A Rand research report in 2012 ("Financial Stability for Nonprofit Organizations-A Review of the Literature") highlighted some key challenges in balancing financial stability with organizational mission. Here are some thoughts on how they apply today.

Risk of reliance on external funding sources and streams

Nonprofits receive funding from a variety of sources including government, service fees, foundations, private donors and membership fees.

President Trump's current proposals for tax reform call for lower individual tax rates and a higher standard deduction, as well as lower corporate rates. Depending upon the nature of the donor base, if these changes are enacted, there could be a significant drop in contributions (especially in states with high state or local taxes, which would no longer be itemized deductions) because fewer individuals would be itemizing their deductions. On the other hand, individuals who have more disposable income in a strong economy may be more generous to causes that they believe are important.

Budget proposals under consideration will call for significant cuts in funding in several areas, particularly those serving human needs and the environment. The National Endowments for the Arts and Humanities (NEA, NEH) is targeted for zero funding and will be eliminated if passed. Nonprofits with missions in these areas will need to take immediate steps to find alternative funding sources as well as finding ways to provide services to those who will turn to them for help when government funding is no longer available.

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The next level of service

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Creating a nonprofit "brand"

"A brand that clearly and consistently communicates a nonprofit's social mission may build trust between the nonprofit organization and its constituents and may ultimately insulate it from competition from other organizations" (Renz et al 2010). Despite limited resources, it is critical to make communities, foundations and other stakeholders aware of the organization and the importance of its mission. Modern technology is a critical factor. Traditionally, many nonprofits have looked to their board and client base for support. In today's environment, sustainable organizations will need to reach out to a wider base.

A presence on Facebook, Twitter and other social media channels is an important way to connect with and educate the community about the mission and reach of the organization; as well as ways that people can help and why they should want to.

The 2016 Republican Party Platform called for repeal of the "Johnson Amendment" which bans 501(c)(3) organizations from participating in election-related activities. The National Council of Nonprofits and other organizations have consistently held that nonprofits have more power and independence to resolve community issues if they are non-partisan. If organizations are branded as a "Republican charity" or a "Democrat charity", it could lessen the public's respect for the nonprofit sector.

Advocacy will be important for every organization and clear communication of constituents' needs becomes even more essential than it has been to date.

Demonstrating value and accountability to funders

Hand in hand with branding and communication of the mission is evaluating financial and programmatic results that demonstrate the value of the organization and its positive impact on those it serves as well as the entire community. Nonprofits need to be financially proactive and boards may need to make difficult decisions about which programs are viable and which simply cannot be sustained without bankrupting the entire organization. Good accounting and data systems with educated users are necessary in order to do that.

Innovation will be critical. Consideration of "clustering "as identified in Nonprofit Workplace Challenges Predicted for 2017, The NonProfit Times, January 6, 2017 means that many organizations will band together to share resources, overhead and personnel to serve a common demographic. Many will focus on specialization in a particular are or service versus considering expansion.

Funding sources at state and local levels may also encourage or require nonprofits to collaborate or merge, a process that is always painful but sometimes necessary. The health care industry (both for-profit and nonprofit) has already experienced this in many areas of the country. Considering collaboration as part of an ongoing strategy will allow management and boards to identify which partners and which structure might be most likely to work for them.

Promoting community engagement and leadership

"Where your treasure is, there will your heart be also." -Matthew 6:21 People support things that they are personally connected with, issues that they care about and, often community organizations which they feel a part of. Volunteers of today may have a different focus. Considering short-term projects that an individual can help with (perhaps online or at home) may be more appealing. Developing a larger group of "community advisors" on specific issues may be a helpful tactic to involve more people who might not be candidates for board membership.

Make sure that board members understand the commitment that is being asked of them. How often does the board meet, what level of financial contribution is expected, are there opportunities for board members to work directly on projects? Andy Robinson in a recent GuideStar Blog, suggests including a "mission moment" at every meeting. Something that reminds the board of why they are serving and a break from the stress of financial and programmatic issues.

It is too early to tell which of the proposals will ultimately be adopted. Changes in tax law, health insurance reform, minimum wage and protections for workers will all have implications for nonprofits and their constituents. UHY LLP will keep you updated on our analysis of potential changes as they occur throughout the coming year.

"Advocacy will be important for every organization and clear communication of constituents' needs becomes even more essential than it has been to date."

By Marilyn Pendergast, Partner (Albany, NY)

PRESENTING THE FINANCIAL STATEMENTS WITH APPEAL TO MAJOR DONORS

Consider the fact that potential donors often have only the organization's audited financials and Form 990 to evaluate the organization's financial strength and how efficiently it would use a potential donation. Evaluating a nonprofit organization's financial statements is different than evaluating statements of for-profit entities because having large amounts of revenue over expenses is not the main goal of the nonprofit organization and many organizations are budgeted to have zero excess revenues over expenses. Also, when the N nonprofit's services are in demand, costs can increase faster than contribution sources – making it initially appear unhealthy. Therefore, it is important to know how potential donors are evaluating the health of a nonprofit entity so financial statements can be presented to appeal to donors.

Since organizations can differ greatly in fundraising needs, administrative costs, revenue sources and many other points of comparison, having information about other organizations that are similar in size and mission can help with benchmarking. If ratios or benchmarks aren't comparable, the organization would be able to be proactive about explaining the reasoning to potential donors. Considering the following indicators of financial health can help the organization show its balance between mission and money.

Statement of financial position

Similar to a for-profit entity, the donor would look at the organization's ability to manage debt, usually through the debt ratio (total liabilities divided by total assets). Some debt is healthy because it allows the organization to grow, but a high ratio could be a red flag to donors. If the organization has a large amount of property and equipment, the donor will also look for cash reserved by the board for up-keep of the property and to cover any unexpected expenses (related to the property maintenance as well as operations in general). The liquidity ratio can help with this evaluation if there are no formally designated reserves. A donor might look at how many months of expense can be covered with liquid assets. At least three to six months of expenses covered by liquid assets is a sign that the organization can weather most unexpected changes. Another item to consider on the statement of financial position is pass-through relationships and amounts due to/from other entities. A high frequency of pass-through transactions where the organization acts as a conduit for donations to other organizations should be part of the mission, as these can increase administrative costs.

Donors will also be looking at the composition of net assets. With the new financial statement presentation standards that will be implanted in 2018, there will soon be only two classes of net assets: donor-imposed restrictions and without donor imposed restrictions (which include board designated). Added footnote disclosures give the organization the opportunity to emphasize how and when resources can be used as well as information about board designations. With the proper amount of disaggregation in presentation, this will help the donor to see what percent of net assets is invested in property, designated for endowments and operating reserves, restricted for purpose or time, held in perpetuity, and held in underwater endowments. More transparency will help donors see whether the unrestricted net assets are liquid and able to be used for general operations.

Statement of activities and statement of functional expenses

The statement of activities can show diversity of income streams, and donors are looking to see that revenue sources are reliable and consistent from year to year. A high concentration of contributions or revenue from one source could be an indication of risk. Common-sizing financials by showing a percent of total revenue for line items could help donors compare year-over-year changes in revenue sources. Revenue from individuals, corporations or foundations is ideal because government funds usually come with substantial reporting requirements that increase administrative costs. Government funds are also subject to change based on government regulation and budget changes. Also, a significant amount of restricted gifts are expensive to track and if a large percentage of contributions are restricted, the organization can't allocate funds where they are needed most and react to changing community needs. In addition, since most restrictions are for use on direct costs, the organization must absorb the indirect costs of delivering programs.

Reporting on special events is important to show fundraising efficiency. If tickets are sold to a special event, the bifurcation between ticket revenue (exchange portion for the fair value of the benefit received) and donation portion included in the ticket price should be appropriately allocated. Proper allocation will ensure accuracy of reported contributions and special events revenue. Calculating the cost of direct benefits to the donor is also important to show how well managed the special event was.

It is also important to make sure that all in-kind goods and services contributed are tracked and recorded as this provides a more complete picture of the activities of the organization. Even though the in-kind

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revenue will equal the expense, it shows potential donors how much more the organization was able to do during the year.

Since the goal of the nonprofit is its mission and not excessive revenue over expense, large surpluses year-over-year isn't the main focus of a potential donor. While consistent surpluses are important in developing reserves and investing in expansion, the organization is also focused on using the maximum amount of current resources to serve the community. There are indications that funds are being used efficiently and donors will look at this.

One of the most important ratios for donors is program expenses divided by total expenses. This is an indicator of how much of the contribution is spent on the organization's mission. Charity rating organizations use this as a key indicator and many suggest that organizations that spend 25 percent or less on operating expenses get the highest ratings. It's helpful to show this ratio over several years as the spending on technology, office space, and experienced staff would ideally allow the organization to grow. Also, allocations between programs and overhead are a high risk area for improper allocation, so reporting too low of expenses can be a red flag to donors. It is most helpful to look at other nonprofits of similar size and mission to make sure the organization is comparable.

Some donors look at the fundraising ratio, but this should be looked at as a trend within the organization over the past several years since it can vary greatly between organization types. Fundraising efficiency can be analyzed by dividing total contributions excluding government grants by fundraising expense. If it is zero, the organization could be receiving mostly government or foundation funding, or be using endowment interest, which the notes to the financial statements and the rest of the statements would explain. Organizations should take care to correctly allocate fundraising expense as this is a high risk area for unreliable reporting. Showing consistent and efficient use of fundraising dollars will encourage donors to contribute.

Statement of cash flows

The statement of cash flows is especially valuable for smaller organizations. Cash flow from operations gives donors insight into whether operating revenue (rather than reserves or debt) is being used to fund operations. The main concern is that the organization has enough cash (or liquid assets) on hand to handle any unexpected expenses or changes in support or revenue. This is also where donors can get an idea of investment in property and other assets that could help expand and grow the organization.

Financial statement disclosures

The disclosures are where the organization can add context to the numbers on the statements. Donors will be looking to get a picture of how the organization operates, what the mission is, and whether activities and programs are consistent with the mission. Make sure that the programs and mission disclosed in the financial statements are consistent with the organization's mission statement. If activities have changed as a result of changes in community needs, consider updating the articles of incorporation to accurately reflect the mission.

Disclosures about the board designated assets are important because donors will look for trends year-over-year. If the board designated net asset amounts are fluctuating significantly from year-to-year, or if there are excessive line items, this could be an indication that the board is trying to lessen the amount of unrestricted net assets available for operations and highlight immediate need for donations. Disclosures on board designated assets help explain what the funds will be used for and how designations fit into the mission of the organization. Having too many board designations could also hurt on the new liquidity disclosures required.

The new financial statement presentation standards that are effective in 2018 add disclosures for liquidity. Information on how an organization manages its resources to meet cash needs for general expenditures within one year of the balance sheet date will be required. If there is too large of an amount for board designated funds, then those may be considered liquid but will not be available for general operations within one year and will hurt liquidity. This is one way that board decisions can have a significant impact on financial reporting. If there are debt payments affecting liquidity disclosures, the organization should add disclosures about their plans to use future funding sources to pay down those obligations.

Conclusion

The action step resulting from knowing how donors use financials statements is to collect information on similarly sized and oriented organizations and use them as a benchmark. If any ratios or points of comparison look off when put up against another organization, be proactive in disclosures or explanation of information provided to donors. Give explanations up front for any potential red flags discussed above and donors will be put at ease before they have to inquire further.

By Jessi Bays,
Manager
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NOT-FOR-PROFIT INDUSTRY INSIGHT

With the increasing complexity of laws and regulations, it's important for associations, foundations, charities, hospitals, schools and other tax-exempt entities to seek out professionals with extensive experience in nonprofit compliance issues. We understand there are many challenges affecting the industry and provide the attention needed to help clients stay focused on their job at hand.

UHY LLP's National Not-For-Profit Practice offers comprehensive audit and assurance, tax planning and compliance and business advisory services to meet the unique, complex needs of nonprofit organizations.

These types of specialized services, which cut across the traditional service lines, demonstrate our philosophy of skilled professionals integrating industry expertise with technical services.

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