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LFMA

Basic Guidelines for Financial Management of Faith Based Agencies

INTRODUCTION AND PURPOSE

This resource was created by Lutheran Services in America (LSA) and the Lutheran Financial Managers Association (LFMA) for the purpose of strengthening policies and practices of financial management for organizations that provide a wide array of health and human services.

What is provided is identification of key components of sound financial management for the CEO and other executive level leaders of small to midsized organizations. Its focus is on organizations that:

a) Have limited financial management experience on staff,
b) Have contracts with accounting firms to provide financial services,
c) Wish to more fully understand fiduciary responsibility, or
d) Desire more complete but simple reporting systems.

A secondary group that might use this as a resource consists of those social ministry organizations (SMOs) that are struggling to maintain or attempting to regain financial stability. The SMO may be seeking guidance based on an identified need to change policies, procedures and practices.

BACKGROUND

Lutheran Services in America's mission is "to serve its members' ministries of service and justice by creating a unified system to develop and maintain resources and relationships." With a workforce of more than 150,000 employees, some 300 member organizations provide services to more than 6 million people annually. These services are provided in all 50 states, the District of Columbia and the US Virgin Islands. Aggregated annual budgets for these organizations exceed $8 billion dollars.

Lutheran Financial Managers' Association (LFMA) is a network for chief financial officers serving within LSA member organizations. LFMA's purpose is "to enable and support the continuing improvement of fiscal management services in Lutheran affiliated / recognized social ministry organizations by providing a vehicle and forum where people in the industry can join together for common sharing and educational experiences."

Within LFMA, members bring a wealth of training and experience. LFMA's commitment is to provide quality educational forums and useful resources to its members and to the church.

Lutheran social ministry organizations demonstrate a long history of faithful service. Some organizations are serving in their third century. Never, though, has providing sound and innovative services been more challenging. Costs of operation are high and quickly rising; legal issues are increasingly complex; operating margins are thin or non-existent; and, the reporting requirements of governmental agencies, upon which an increasingly high percentage of operating budgets depend, are burdensome. Further, these ministries are operating within a cultural climate that, thankfully, insists on higher levels of competence, integrity and accountability.

The ministries affiliated and recognized by the Evangelical Lutheran Church in America and The Lutheran Church-Missouri Synod, strive to integrate their time-honored faith tradition with excellence in business practices. Within these contexts, the financial operation of social ministry organizations is challenging. Guided by the values of stewardship, faithfulness and integrity, social ministry organizations are committed to the highest levels of competence.

OBSERVATIONS

Assessments conducted over the past few years by LSA's OASIS (Organizational Assessment and Intervention Services) program, Ministry Partnership Reviews of the two national church bodies and discussions within the LFMA network have identified several trends and financial management practices in a variety of SMOs that have indicated a need for a resource of this type. Several observations include:

1) Some SMOs do not have a CFO on the senior management team, a qualified treasurer on the Board of Directors, or anyone within the leadership of the SMO, who has a solid understanding of financial management practices or the financial condition of the SMO.

2) Financial problems are frequently not addressed early enough to prevent destabilization. One tool to help identify issues sooner is "10 early warning signs of financial trouble."
(Attachment 1)

3) Budgets and capital expenditures are not sufficiently based on strategic plans or valid assumptions, and capital expansion plans are often overly optimistic.

4) Cash availability and flow is tracked on an irregular basis.

5) Inaccurate or incomplete balance sheets and financial statements are provided to the Board by the CEO, often not on a regular schedule.

6) The CEO and the Board do not fully understand their respective fiduciary responsibilities to monitor and evaluate the budget process and are not aware of key financial indicators. The CEO may be managing the finances in isolation or without adequate Board oversight.

7) Internal controls are often lacking, or they are poorly defined and inconsistently followed. Occasionally, there is no system in place to manage accounts payable and accounts receivable.

8) Recent changes in financial management and increased compliance requirements have been imposed by the Federal Government's Financial Accounting Standards Board, commonly referred to as FASB, and the implications of the Sarbanes-Oxley Act of 2002. Sarbanes-Oxley is officially known as the "American Competitiveness and Corporate Accountability Act of 2002" and was written primarily for the for-profit world. A summary is attached. (Attachment 2)

These trends and changes have intensified the need for additional internal controls, improved policies and procedures, and increased accountability. They are requiring new standards for SMOs and other not-for-profits. One good resource to increase CEO's understanding of Sarbanes-Oxley is "The Financial Reporting Practices of Nonprofits" by Patricia Heinz, published by the Alliance for Children and Families.

It is also very important to know the basic definitions and concepts of accounting and financial management. The language used in many regulatory requirements and financial procedures can be very confusing and difficult to understand. The CEO is encouraged to ensure that he or she and the Board use the same definitions and principles. One suggested listing of definitions is attached. (Attachment 3)

CEO AND BOARD ROLES AND RESPONSIBILITIES

A clear understanding of the roles and responsibilities of the CEO and the Board of Directors is critical to ensure good financial management, oversight and stability of the organization.

1) The CEO is hired by the Board and is accountable to the Board. The program and administrative staff work for the CEO. While program managers may provide input into the budgeting process and monitor their program's revenues and expenses, they are responsible to the CEO for overall financial management. This also helps ensure that the organization has an alert, fiscally aware staff, and an integrated financial management system.

2) The CEO must be trained in financial management procedures and have a backup staff member trained as well. This will serve three purposes, i.e. when the CEO is absent or attending to other duties there is someone who can respond to financial matters; it provides assistance to the CEO in financial management; and it can serve as an internal check and balance system for the SMO.

3) The CEO must be responsive to the Board. The Board's responsibility is to hold the CEO accountable for the proper development, implementation and execution of the budget and financial plan and to ensure compliance with policies and external regulatory requirements.

4) The CEO should regularly meet with the Board's finance committee, the treasurer and the accountant regarding finances. This requires interaction outside of the scheduled Board meetings. The finance committee generally meets monthly and reviews the quality, timeliness and accuracy of reports, examines how current data compares with budget estimates, analyzes historical trends and ensures the integration of this information into the financial plan.

5) The CEO prepares an annual operating budget for the Board's approval.

6) The CEO develops and implements the financial management procedures and practices. These must be integrated in and based on the existing Board policies and in keeping with strategic plans, direction and vision.

7) The CEO ensures an annual audit is conducted. The Board, ideally through its audit committee, approves and accepts the audit, monitors the necessary changes that are indicated, and ensures that the recommendations are implemented.

8) The CEO generally assists the Board in the recruitment and development of Board members that possess the skills and experiences to provide oversight of financial management processes.

9) The CEO encourages and provides opportunities for staff and Board training in understanding basic financial statements, including balance sheets; cash flow reports, audit reports and letters, budgets, development plans and investment plans.

10) The CEO follows the guidelines established by the Board for the budget such as restrictions or priorities.

11) The CEO and the Board, jointly, develop fiscal policies that identify performance indicators for budget planning and execution, cash flow management, debt, investment strategies and other guidelines.

In summary it is imperative for all SMOs, but particularly for organizations without a CFO, to have financially skilled individuals on the Board. If that is not possible, then the CEO should have access to one or more individuals who are familiar with corporate financial and business principles, preferably a CPA, a banker or a CFO of another entity. Additional training, and in some situations retraining, is necessary to ensure that each of these individuals has a working knowledge of the current operations of the SMO and recent changes in regulatory requirements of not-for-profit financial management.

SPECIFIC CEO CONCERNS REGARDING FINANCIAL MANAGEMENT

One of the CEO's primary functions is to ensure the Board has consistent, timely, and reliable financial information, as well as pertinent programmatic information.

Since the CEO also must prepare the budget, it is important to understand the budgeting process. An outline of a work plan and selected steps are included as an attachment. Additional comments on the budget including an example of a SMO budget management policy are covered in the section on financial stability. (Attachments 4 and 5)

To provide good reports there are several basic questions that should be asked on a regular basis. In a presentation at a recent LSA CEO training session one of the CEOs of a Lutheran SMO asked three questions that reveal the most important pieces of information a CEO must know about the SMO's financial condition:

a) *Where is the cash coming from?*
b) *How is the cash being expended?*
c) *How much cash is in the bank?*

To answer these questions, CEOs can gather significant information from a number of sources including financial institutions, auditors, resource development staff and accounting staff. For example, from the accounting staff or contractors they can request regular financial statements, monthly "aging" of accounts receivable, daily and weekly cash reports and monthly/quarterly cash flow reports. The development staff can also provide information such as monthly reports on annual giving. This is useful information that is as important as the listing of major gifts and activity reports generally provided to the CEO.

Every SMO is encouraged to have an annual audit and in some situations it is required to have an annual audit. The Board selects and hires the auditor and the CEO works with the auditor or audit team. Some Boards and CEOs are unsure of what to ask for, what they expect to receive from the audit and how to relate to the auditors and the audit process.

SMOs should seek and expect a certain experience level in audits of not-for-profits and it is necessary to ask if the auditors have experience in the specific "industry" of the SMO, e.g. long term care, if the SMO provides this type of service. This experience can help the SMO by identifying variances in operations from industry standards. Thus, the more experience the auditor has, the greater the help to the SMO. Organizations also can expect to have the auditors display a level of healthy skepticism that will help lead to a complete and competent audit.

The length of time an audit takes varies and is based on the size of the SMO. It is also somewhat dependent on how closely the established internal controls and management procedures have been followed.

The audit report should include an opinion page, a balance sheet, statements of operations, changes in net assets, cash flow, and notes to the financial statements. The audit may also include a management letter, special reports, a SAS 61 letter, or a constructive comments letter. If internal controls are not in place or not followed, the SMO can expect to have a number of comments regarding such in the management letter.

Beyond the audit, financial management information gathered by the CEO covers a variety of purposes. It may be presented to several diverse groups - Board of Directors, senior staff, direct care staff, donors, the business community, or stakeholders. Occasionally limited information is provided to clients or residents. The format for presenting this information may vary, but it usually includes quarterly or monthly financial statements, simple to read narratives, audit reports, the SAS 61 letter, the budget and the annual report.

Nonprofit corporations, by definition, don't exist to make a profit, but to fulfill their charitable purpose. However, under federal tax laws, a nonprofit can bring in more money than it spends. In other words, your nonprofit can make a profit as long as the activities are related to the nonprofit's purpose.

IRS Form 990 is a federal reporting requirement that is informational in nature. In the past some religious not-for-profit organizations have been able to avoid this filing requirement. However, it is increasingly important for all organizations to make clear, transparent information available to the public. In fact, potential donors are becoming more sophisticated and many will not consider a gift to an organization unless they have been able to view the organization’s Form 990. For these reasons it is suggested that all Lutheran social ministry organizations complete Form 990 annually. Be sure to completely answer all questions on the form. Since this can be a complicated process, it might be a good investment to hire an accountant to complete the form. However, the organization should check the form for accuracy before it is submitted.

Sometimes nonprofits make money in ways that are not related to their purpose. This "Unrelated Business Income" is subject to income taxes. In preparing Form 990, "unrelated business income" must be disclosed. It is suggested that a tax expert advise your organization on reporting this income. Under certain (unusual) circumstances, excessive taxable income may put the organization’s tax exempt status in jeopardy.

In today's electronically driven world, accounting software and the proper use of technology is important. There are many software variations on the market. The proper choice, staff training and use of such will ensure reliable reports, facilitate the accounting process and provide quick retrieval of information for various audiences and purposes. Perhaps hiring a CFO or financial manager as a consultant to assist the SMO in selecting software and doing staff training will be money well spent.

Another area that requires diligence is how to select a financial institution. Part of this decision depends on the nature and size of the SMO. Several key items to assess are:

- *Is the bank within reasonable geographical access?*
- *Does the bank have modern services(electronic banking, E-transfers etc.)?*
- *Does the bank offer full services such as term loans, lines of credit, interest bearing checking accounts, and, perhaps, credit card services?*
- *Are the bank's loan and investment rates competitive?*
- *Are its fees reasonable?*

For most SMOs medium sized banks or even smaller banks are fine. Bigger banks are not necessarily better, although there is some dispute on this issue. In fact, the SMO may wish to conduct its business with two banks and keep them competing for the organization's business. This can help ensure the SMO receives competitive rates, minimize fees, leverage other services, and lower costs. What is of prime importance, however, is to ensure that the bank understands the business of the SMO, and that it has an interest in the SMO.

Another issue is whether to include the banker on the Board of Directors. In many SMOs this may be an acceptable practice, and in smaller communities this may be difficult to avoid. The critical issue in placing your banker on the Board is the inherent or potential conflict of interest and determining whether this outweighs the relationship building benefits of having the banker on the Board.

One of the "security blanket" items for a CEO to consider is the line of credit. A line of credit is a valuable tool when it is properly used, but it can get out of control. When the SMO selects its bank and establishes the banking relationship, this should be considered as part of the negotiated agreement.

A line of credit should be paid off completely once a year, otherwise it is considered long term financing. Lines of Credit should be used only for operating expenses and only to meet a short term cash need. This may be due to timing of revenues received, timing of material expenses or timing of program volume etc. The SMO can use a line of credit to balance a budget but should only do this for one year. It should be paid off in the subsequent year. A suggested line of credit level is equal to 30 days of operations. Thus, a $12M program would need a $1M line of credit.

Debt Ratios is another management tool. It is something that is important for a CEO to understand to be an effective financial manager. SMOs that are primarily service entities, generally are advised to stay within 60 cents to each dollar of assets. This is a Debt to Asset ratio of .60. For SMOs relying on capital assets to generate revenues, such as housing and assisted living, a ratio as high as .75 may be acceptable. However, to determine the debt ratio or number for a specific SMO requires looking at the entire financial situation. This includes the nature of the program, i.e. are they social service or residential based? Do they monitor cash flow? What are both the short and long terms of their debt, the interest rates, the bank covenants and liquidity?

A question is frequently raised about employing a cash versus an accrual accounting system. All CEOs should clearly understand which system they are using. Cash basis accounting records income when the cash is actually received and records expenses when the cash is dispersed. Accrual accounting records income when it is earned, whether or not payment was received, and records expenses when incurred and not when they are paid. Many SMOs are on the accrual accounting system even though many of the government agencies they deal with are not.

Some SMOs use the annual budget to develop a potential for fundraising. Certain services are often provided that are not reimbursed through the state and federal rate methodologies. The strategy of the SMO may be to approach a potential donor with this budget shortfall to give them something specific to fund.

Some of the fundraising done by an SMO is for the support of day to day operations. At other times funds are raised for capital. Capital campaign revenues and expenses are reported as non-operating income and expenses. When dollars are raised in support of programs, the fundraising revenues and expenses are integrated into the operating statements.

FINANCIAL STABILITY QUESTIONNAIRE

A CEO who desires to maintain or regain financial stability at an SMO could gain additional clarity and reassurance by asking a number of questions. One set of questions, used with SMOs that were facing financial instability, was developed recently by the financial management staff of Lutheran Social Services of Michigan. This questionnaire includes:

1) CASH -
What is the current cash situation?
Is the agency running out of cash?
What restricted funds are available and are any used for operations?
Are the payables and receivables timely?
Where else can cash be found?
What other situation will require additional cash?
What are the monthly cash requirements for payroll, rent and utilities, debts?
Are there any expenses or revenues outside the control of the organization that are expected to change significantly in the near term?
What are the cash needs to get from the present to the future?
What is the prospect of repayment of loans?
What is the current line of credit available?
How will cash be obtained and what obligation will likely be placed on the organization?

2) BANK RELATIONSHIPS
What is the nature of the organization's relationship with the bank?
Is it a short term business relationship or a long standing one with an interest in the mission of the organization?
What other financial institutions are involved with the organization?

3) BALANCE SHEET AND FINANCIAL STATEMENTS
How accurate is the balance sheet and is it timely?
What items are remarkable?
Are there significant changes from last month or the last quarter?
Are the financial statements adequate, timely and accurate?

4) BUDGETING

Does the organization have a current budget and in sufficient detail?
When was it adopted by the Board?
Is there a functioning finance committee?
What are the key assumptions on which the budget was based and are they reasonable?
Can the budget be changed by the Board?
How does the organization's overall planning process contribute to the budget?
What is the difference between the budget and the actual financial performance for the current year?
Is the future planned budget realistic in light of the current situation?
Are there specific limitations placed on the CEO?

Not included in this listing are governance and monitoring requirements, timetables, competencies of staff, management of restraints, and any structural or staffing changes needed to re-stabilize the SMO.

ESTABLISHING AND MONITORING KEY FINANCIAL INDICATORS

Good fiduciary oversight by the Board requires a CEO to provide the Board sufficient financial information on a consistent basis. Information must also be based on relevant criteria in order to monitor the overall direction of the SMO. The following steps are recommended:

1) Establishing Critical Indicators

Indicators can be based on operational, human resource, or financial criteria. Each indicator must be objective in nature and calculated based on data generated by the SMO. Generally, there should not be more than six to eight critical indicators. Each indicator should have a clear tie to the budget, strategic plan, and SMO mission statement. The purpose of the indicators is to provide the Board with a tool to monitor the effectiveness of meeting those strategies. (Attachment 6)

2) Establishing Performance Goals

After developing the critical indicators to be monitored, the SMO must establish performance targets for each indicator. Information sources such as industry averages or historical performance may assist in arriving at those targets.

3) Establishing Annual Operating Budget

A budget is a dynamic document that is to be used for on-going decision making throughout the year. Key components of the budget are:

- Financial projections and assumptions summary. Useful information includes a comparison with the prior year, current year, and projection for the next year's performance.
- Statement of Cash Flows

4) Establishing Capital Budget Policy

Beyond generating sufficient monies to meet its operating expense needs, each SMO must generate financial resources to:

- Fund current repair and replacement needs
- Fund planned research and new program development
- Fund reserves for future needs whether foreseen or unforeseen

As a rule of thumb, an SMO that is able to place 50% of positive cash flows after operating costs into reserves will generally be building sufficient balance sheet equity for economic growth. Establishing capital budget criteria should be a policy transcending year to year budgets and based on the overall long-term goals of the SMO.

5) Establishing the Fundraising Plan

Ask the following questions related to generating revenues and development activities:

- What is expected for current fundraising?
- What efforts will be made for deferred giving?
- Who will be responsible for the fundraising efforts?
- What budgeted dollars will be available for these actions?

6) Establishing an Investment Policy

There is a clear distinction between what monies are available to meet the day to day operating costs of the SMO and those monies put aside for future use. Monies put aside need to be further identified as restricted use, expected time period for use, or those restricted to endowment.

- Create investment policy
- Consider outside investment management

- Establish periodic performance reporting

MEASURING FINANCIAL PERFORMANCE - KEY INDICATORS AND DEFINITIONS

The measurement of financial performance is frequently left up to the auditors, or it is invoked when a SMO is facing financial instability. While this is primarily a responsibility of the Board, as it governs the SMO, it is equally critical for the CEO to understand the indicators and ensure that measures are in place for their monitoring.

Depending on the nature of the SMO, key information that requires monitoring will vary. At a minimum, the following financial indicators should be considered for periodic monitoring. The importance is not only to calculate key indicators of the SMO but also to monitor the trends over a period of time. (Attachment 7)

Profitability

1) Operating Margin - measures the percentage of operating revenues retained after payment of operating expenses.
2) Net Margin-same as operating margin but also includes non-operating revenues (e.g. investment income). This measures the percentage of total income over expenses.
3) Debt Coverage Ratio-measures the ability of the organization to pay its long-term debt through operations.

Liquidity

1) Days Cash and Investments On Hand-measures days of cash and investments available to cover operating expenses.
2) Days Accounts Receivable-measures the length of time between when services are delivered and the payment for those services is received.
3) Current Ratio-measures liquidity to pay current obligations.

Capitalization

Debt to Total Assets-measures the percentage of the SMO's assets that are owned by creditors.

Revenue Management-Program Utilization

1) Occupancy-measures the effectiveness in utilizing facility units of service.
2) Mix of Payer Sources-measures the SMO's exposure to risk based

on payer source changes.

EXTERNAL INFORMATION RESOURCES

In measuring programs using benchmark indicators, it is important that the SMO use comparative data and trends from comparable agencies. A CEO may wish to investigate and request assistance as needed from:

- State Industry Associations
- Federal Industry Associations
- Available Industry Publications
- Lutheran Financial Managers Association
- Competitor Comparisons (www.guidestar.org provides information from Form 990 submissions that can help identify similar organizations)
- Consultant Sources
- Independent Auditors

Attachment 1

10 EARLY WARNINGS SIGNS OF FINANCIAL TROUBLE

Although financial problems can come out of the blue, there are often danger signals that occur well in advance of real catastrophe. These include:

1. Your organization consistently spends more money than it receives in revenue.

2. You are not paying payroll taxes in a timely fashion.

3. Payables, the amount you owe to others, are mounting up and going unpaid.

4. You regularly dip into restricted or deferred funds for today's expenses, coming up short later when the special project is ready to go.

5. More than 50 percent of your accounts receivable, the money others owe you, is 120 days or older.

6. You consistently need to get an advance from the United

Way or other contract source to meet today's expenses.

7. You have no idea how your organization got into such a financial mess, and you don't know how to begin to pull out of it.

8. You don't know how much the organization owes, and you don't know how to find out.

9. Lack of money has become the focus and dominant point of conversation at staff and board meetings

10. You feel hopeless or are losing sleep at night because of the financial condition of your organization.

Source:
All the Way to the Bank: Smart Nonprofit Money Management,
Susan Kenny Stevens - Author

Attachment 2

THE SARBANES-OXLEY ACT AND IMPLICATIONS FOR NONPROFIT ORGANIZATIONS

The American Competitiveness and Corporate Accountability Act of 2002, commonly known as the Sarbanes-Oxley Act, was signed into law on July 30, 2002. Passed in response to the corporate and accounting scandals of Enron, Arthur Andersen, and others of 2001 and 2002, the law's purpose is to rebuild public trust in America's corporate sector. The law requires that publicly traded companies adhere to significant new governance standards that increase board members' roles in overseeing financial transactions and auditing procedures.

While nearly all of the provisions of the bill apply only to publicly traded corporations, the passage of this bill should serve as a wake-up call to the entire nonprofit community. If nonprofit leaders do not ensure effective governance of their organizations, the government will step forward and also regulate nonprofit governance. Indeed, some state attorneys general are already proposing that elements of the Sarbanes-Oxley Act be applied to nonprofit organizations.

Nonprofit leaders should look carefully at the provisions of Sarbanes-Oxley and determine whether their organizations ought to voluntarily adopt particular governance practices. This resource will review those provisions and assess their relevance to nonprofit organizations.

MAIN PROVISIONS OF THE SARBANES-OXLEY ACT

The following sections cover each of the major provisions of the new law and discuss their relevance to nonprofit organizations. There are a number of alternative sources offering recommendations for how nonprofit leaders should implement various provisions of the new law.

1. **Independent and Competent Audit Committee**
   - All nonprofit organizations that conduct outside audits, particularly medium to large organizations, should have an audit committee and should separate the audit committee from the finance committee.
   - Where the finance committee's members are non-compensated and less than 50% of the committee membership also serve as board members, it may be acceptable to combine the audit and finance committee functions.
2. **Responsibilities of Auditors**
   - Nonprofits should ensure that the auditor or auditing firm, or at least the lead and reviewing partners, are rotated every five years.
   - Nonprofit organizations should be cautious when using their auditing firms to provide non-auditing services except for tax preparation, which should be approved in advance, while the firm is contracted to provide auditing services.
   - Audit committees should require auditing firms to disclose to the audit committee all critical accounting policies and practices used within the organization as well as share with the audit committee any discussions with management about such policies and practices.
3. **Certified Financial Statements**
   - CEOs and CFOs, while they need not sign off on the financial statements of the organization, do need to fully understand such reports and make sure they are accurate and complete. Signing off on the financial statements provides formal assurance, however, that both the CEO and the CFO have reviewed them carefully and stand by them.
   - The CEO and CFO should review the Form 990 or 990-PF before it is submitted to ensure that it is accurate, complete and filed on time.

- Regardless of whether the CEO and CFO certify the financial report, the board has the ultimate fiduciary responsibility for approving financial reports. Just as the financial and audit reports are reviewed and approved by the audit committee and the board, the Form 990 or 990-PF should also be reviewed and approved.

4. Insider Transactions and Conflicts of Interest

- To guide the board and staff in independent decision making, the organization must have a conflict of interest policy with disclosure and this policy must be enforced without fail.

5. Disclosure

- Nonprofit organizations should improve the timeliness, accuracy, and completeness of the Forms 990 or 990-PF by filing electronically when that is available to them.
- Audited financial statements should be easily accessible for review.

6. Whistle-Blower Protection

- Nonprofits must develop, adopt, and disclose a formal process to deal with complaints and prevent retaliation.
- Nonprofit leaders must take any employee complaints seriously, investigate the situation, and fix any problems or justify why corrections are not necessary.

7. Document Destruction

- A nonprofit organization should have a written, mandatory document retention and periodic destruction policy. Such a policy also helps limit accidental or innocent destruction.

Source: "The Sarbanes-Oxley Act and Implications for Nonprofit Organizations" The Board Source and Independent Sector, 2003.

Attachment 3

GLOSSARY OF TERMS AND BASIC CONCEPTS

Accounting Period - The life of a SMO is divided into periods of time at the ends of which test readings of the progress in the form of financial statements are prepared. An accounting period of one year in length is the standard. The one year accounting period is often broken down into 12 monthly interim accounting periods.

Accrued Expense - Expenses at the end of an accounting period that have been incurred but are not yet due to be paid.

Audit - A report of the financial records of a SMO that have been thoroughly examined by an independent certified public accountant. This report always includes the official year end financial statements. An audit is usually completed on an annual basis that coincides with the established accounting period.

Capitalized Asset - An asset having a useful life longer than a single accounting period.

Cash Flow - The flow of cash into and out of an organization.

Change in Net Assets - Operating gain or loss plus non-operating income.

Contributions - Gifts of cash or other valuables which are given to a SMO. Some contributions are restricted as to use.

Current Assets - Cash or other types of assets that will be converted to cash within the next accounting period.

Current Liability - Payments that will require the use of cash within the next accounting period.

Depreciation - Provides for the gradual expiration of a fixed asset over the useful life of that fixed asset. A fixed asset is a physical property having a useful life longer than a single accounting period.

Earnings - The balance of revenue after the deduction of expenses.

Endowment - A non expendable asset. Only the income produced by such assets can be expended.

Equity and Fund Balance - In the not-for-profit industry equity and fund balance are used interchangeably with net assets. Assets minus liabilities equals equity.

Leverage - The use of borrowed money to gain economic advantage and results.

Liquidity - A measure of the SMO's solvency; that is, its ability to pay bills on time, to fund payrolls, and to withstand occasional financial crises.

Long Term Stability - A measure of the level of net capitalized assets leveraged by debt, how much of the SMO is financed by creditors, and the capacity for assuming additional debt.

Net Working Capital - The remainder of current assets after the deduction of current liabilities.

Net Assets or Net Worth - The remainder of total assets after the deduction of total liabilities.

Non Current Assets - Assets that are not intended to be converted into cash within the next accounting period.

Non Operating Income - Income that is not directly earned from the delivery of services (typically contributions and investment income).

Operating Efficiency - A measure of the overall productiveness of the assets employed in a SMO and a measure of the annual operating results.

Operating Expense - Expense that is directly related to the delivery of services.

Operating Gain or Loss - Operating income minus operating expenses

Operating Income - Income that is directly earned form the delivery of services.

Operational Asset - Assets that are not categorized as intangible assets or fixed assets.

Percentage - An expression for measuring a part of the whole.

Profit Margin - In the not-for-profit industry this is used interchangeably with change in net assets

Ratio - An expression for measuring the relationship of two or more values.

Revenue - This is used interchangeably with income.

Statement of Activities - A statement showing the results for an accounting period by offsetting income against expense.

Statement of Financial Position - As list of assets (what the SMO owns) liabilities (what the SMO owes) and net assets (assets minus liabilities).

Trend - The general movement in the course of time of a statistically detectable change.
Source: Marty Glood. An Introduction to Financial Analysis. Evangelical Lutheran Church in America. © 1993, revised 1996.

Attachment 4

The Budget Process

Suggested Work Steps in the Budget Process

1. Introduction
   - Define who you are
     (all entities, consolidated or separate)
   - What do you want to accomplish?
     1. Strategically and how will you apply this to your SMO?
     2. Goals of the SMO?
     3. Where is the industry - Losses, New business development?

2. What is a Budget?
   - Financial plan
   - Projection of revenues and expenses
   - List of resources & obligations
   - Capital Budgets are separate

3. What is the Budget used for?
   - Planning
   - Monitoring
   - Communicating with staff & for governance purposes
   - Measure various plans of action

4. Budget Process
   - Mathematical (last year +/- %)
   - Analytical (line by line)
   - Somewhere in between is the best position
   - Most issues involve staff and it is important to list out the assumptions
   - Time line should begin three months before the end of year and be completed one month before the end of the year.

5. Create a Pro-forma Budget, of which there are many styles

6. Assemble Budget team
   - CEO should not do it all alone - Include staff in the process
   - Committee is an option that will guide the staff so they do not view their work as "sink or swim"

7. Review Assumptions
   - Program Changes
   - Change in Payer Sources
   - Salary increases (steps)
   - Occupancy levels if in residential care
   - Inflation

8. Assemble / Review / Revise / Implement
   - Underlying assumption is that the CEO is a professional

9. Issues
   - Labor pools
   - Ratio of staff to people served
   - If losing dollars, what is the CEO going to change?

10. Conclusion
   - Create a Preliminary Budget then review for Final Budget
   - Communicate, communicate, communicate
   - When times are difficult - "get a buy in" from staff and Board.
   - Design the key tools
   - Don't wing it!
   - Budget to create change within the SMO!

Items for Inclusion in Budget Document

- Executive Summary (This highlights changes in assumptions, summary of performance and year to year trends)
- Balance Sheet
- Cash Flow Projection
- Staffing Assumptions
- Critical Indicators (debt coverage, days cash etc.)

Source: David Jurkowski and others, "Financial Management Policies," Lutheran Social Group, Inc. Jamestown, NY

Attachment 5

Financial Management Policies
Budget

Overview

Budgeting is an integral part of managing any organization in that it is concerned with the translation of organizational goals and objectives into financial and human resource terms. A budget should be designed and prepared to direct the most efficient and prudent use of the organization's financial and human resources. A budget is a management commitment to a plan for present and future organizational activities that will ensure survival. It provides an opportunity to examine the composition and viability of the organization's programs and activities simultaneously in light of the finite available resources.

The advantage of budgeting includes:

- Requires periodic planning
- Fosters coordination, cooperation and communication
- Forces managers to quantify their plans
- Establishes a frame work for evaluation of performance
- Creates an awareness of the cost of operating a business
- Satisfies legal and contractual requirements including financing covenants
- Orients activities towards organizational goals

Preparation

It should be the policy of the organization to prepare annual budgets by program and on a consolidated basis. Budgets are prepared generally on a fiscal year basis but there may be situations that require preparing such on a calendar year.

The basis for each budget is actual historical information, market and customer influence, current and proposed federal and state legislation affecting both revenues and expenses, state program associations input, goals and objectives of each specific program administrator, and anticipated cost of goods and services from third party vendors. This information is developed and compiled in a comparable budget format by the accounting personnel of each program in conjunction with the program administrator. All efforts are made to drive input and accountability to the department level, resulting in more realistic budgets. Final program budget accountability, however, rests at the program administrator level.

Adoption

Once the detailed program budgets are developed, they are reviewed and approved by the respective program leadership and recommended for approval to the organization's finance committee. The finance committee in turn reviews and recommends adoption of the budget(s) to the Board of Directors. The budgets are reviewed and approved by the Board.

Monitoring Performance

It should be the policy of the organization to monitor its financial performance by comparing and analyzing actual results with budget projections. This function should be accomplished in conjunction with the monthly financial reporting process described earlier.

On a monthly basis, financial reports comparing actual year-to-date revenues and expenses with budgeted year-to-date amounts, along with appropriate variance explanations, shall be produced by the accounting department and distributed to each employee with budgetary responsibilities. Depending on the program requirements, monthly meetings are held with program administrators and appropriate program staff as well as the President/CEO, CFO and Corporate controller. Revenue and expense variations are discussed and program adjustments are made, if necessary, to meet budget expectations.

Source: David Jurkowski and others, "Financial Management Policies," Lutheran Social Group, Inc. Jamestown, NY

Attachment 6
Critical Indicator Development Steps

1. Define Critical Indicators
   - Gauges that indicate organizational success
   - Gauges that indicate threats to success

2. Categorize Critical Indicators in three categories
   - Things that should be continually tracked and reported to senior management on a regular basis (i.e., weekly, monthly)
   - Things that should be tracked regularly and reported to senior staff when they reach a predetermined threshold signifying "significant risk"
   - Things that should be tracked regularly and kept up-to-date so that data is available to senior staff when requested

3. Define all possible risk thresholds for Critical Indicators

4. Determine feasibility of tracking Critical Indicators in terms of time, cost and availability of data vs. benefit of having the information

5. Determine who will be accountable for
   - Collecting data
   - Maintaining data
   - Generating reports

6. Define what information needs to be included in reports in order to provide clear, brief and useful management information

7. Determine when and/or how often critical information should be gathered and disseminated in order to reduce the potential for risk

8. Define and decide on risk information that should be presented to the board
   - How it should be compiled
   - How it should be presented
   - How often they need it

9. Define and decide on risk information that should be presented to the rest of the organization's managers
   - How it should be compiled
   - How it should be presented
   - How often they need it

Source: Kenneth Borle and others, "Critical Indicators," Ecumen 2004

Attachment 7
Measuring Performance - Critical Indicators

Profitability	**Goal**	Threshold **(Flag)**	**Actual**
Operating Margin	1.0%	.5%	1.90%
Net Margin	3.0%	2.0%	2.98%
Debt Coverage (Excluding Contributions)	2x	1.5x	2.6X
Liquidity			
Days Cash and Investments	60	40	50
Days Accounts Receivable/LTC	28	31	27
Current Ratio	2x	1.5x	1.6X
Capitalization			
Debt to Total Assets	50%	60%	50%
Revenue Management			
Nursing Home Case Mix (RUGS)		% Change	
Census Residential	98%	94%	97%
Census Nursing Homes	94%	90%	93%
Other Issues			
Payer Sources		%	
Volunteer Hours		By Program	
Staff Turnover		By Program	

** Threshold or Flag identifies a specific indicator in need of direct action or explanation.*
Source: Kenneth Borle and others, "Measuring Performance," Ecumen 2003

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The information provided in this document is not intended to be complete or exhaustive. In some respects this could be considered a primer on financial management of a social ministry organization.

The work group is fully aware of and encourages the reader to use many of the excellent resources available within the financial community of nonprofits. A secondary intent is that this document will enhance the CEO's understanding of financial management and, by applying some of the principles, enable the CEO to feel more confident in preparing, providing, and maintaining financial information for the social ministry organization.

Resources

In measuring programs using benchmark indicators, it is important that the SMO use comparative data and trends from comparable agencies. A CEO may wish to investigate and request assistance, as needed, from any number of sources. Some of the most useful resources are websites, others are in print such as pamphlets and books and others are national and regional associations. Several of the resources listed below were used in developing these guidelines.

- State Industry Associations
- Federal Industry Associations
- Available Industry Publications
- Lutheran Financial Managers Association
- Competitor Comparisons (www.guidestar.org provides information from Form 990 submissions that can help identify similar organizations)
- Consultant Sources
- Independent Auditors

- "Free Management Library", www.managementhelp.org
- "Management Assistance Programs for Nonprofits", www.mapfornonprofits.org
- Heinz, Patricia A. "The Financial Reporting Practices of Nonprofits", Alliance for Children and Families, 2003
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