

CERINI & ASSOCIATES, LLP | CERTIFIED PUBLIC ACCOUNTANTS
PRESENTS



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BRINGING A UNIQUE UNDERSTANDING OF KEY ISSUES FACING NOT-FOR-PROFIT ORGANIZATIONS

The summer is ending. Temperatures are starting to cool. The pandemic seems to be relatively under control. Just when the world seems to be simmering down and returning to normal, the next challenge rears its ugly head. The economy, hobbled by inflation, supply chain disruptions, government and Federal Reserve interventions (*for better or for worse*), and the dark cloud of general uncertainty, is sputtering. While the pandemic brought with it certain challenges, it also brought relief in the form of direct government assistance (*Paycheck Protection Program and Economic Injury Disaster loans, Employee Retention Credits (ERTC), Provider Relief Funds, et al*) and hybrid work-related cost savings. These newer economic challenges are almost purely finance-related, and likely won't be met with bailouts of any kind. It's time for nonprofits to lace up their boots and soldier on. We're here to help.

In our interactions with nonprofits, we often find that nonprofit leaders who lack financial backgrounds are ill-equipped to understand, monitor, and assess financial performance and standing of their organizations. We've provided a primer on nonprofit financial statements, with emphasis on key trends, benchmarks, and ratios to look for, along with how to interpret them.

With the economy slowing down and teetering on a full-blown recession, organizations need to exercise even more prudence when operating their programs and administration. For calendar year-end organizations, you're likely entering budget season at a time when estimating what may come next is virtually impossible. We've written an article about budgeting in these down times and how to develop effective contingency budgets, reporting, and monitoring to effectively navigate your organization through rough waters.

An unfortunate byproduct of the inflationary environment we find ourselves in, along with the associated volatility in equities markets, is the decline in value of many organizations' endowment funds. Endowments are tricky beasts that have implications and ramifications far beyond simply tracking investment performance. We're sharing content on the significant legal angles of maintaining endowment funds, along with accounting, finance, and reporting considerations.

We mention above the ERTC program, which can provide significant tax credits to organizations that suffered revenue losses during the pandemic or were forced to close operations due to unavoidable government orders. All organizations should at least be exploring the possibility of applying for ERTC credits if they haven't done so yet. It's not too late, but the window is closing. The rules are convoluted, but we've become experts in the qualifications and filings. Let us know how we can be helpful in this regard.

Stay connected with us this Fall as we continue to give back to the nonprofit sector. Join us each month for the Cerini Connection, an interview series focusing on timely topics impacting organizations like yours. Also be on the lookout for an upcoming board training webinar series, during which our nonprofit professionals will dive more deeply into subjects that are relevant to Board members and other key stakeholders of nonprofit organizations. As always, if there's anything we can provide assistance with, we're only a call or email away.

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BUDGETING IN A DOWN ECONOMY



Budgeting for all businesses, including not-for-profits, can be a daunting task even with all economic conditions being ideal. The personnel responsible for the fiscal task of creating and monitoring an organization's budget often spend a significant amount of time and effort, only to realize that when economic conditions take a sudden and dramatic turn, their original efforts hold little value under the new economic environment. Under volatile conditions, budgets and forecasts can change from month to month or even week to week in extreme cases. Therefore, the need to establish reliable dynamic budgets that have been pre-approved and can be quickly implemented when changes occur, has become an increasingly important skill for fiscal managers so that budget modifications can be timely initiated when economic conditions suddenly change. These are some approaches you may find useful when budgeting in a down economy.

SCENARIO BUDGETING

During more stable economic times, budgeting is a typical exercise done and set with minor updates throughout the year. However, when the economic conditions are negatively impacted and uncertainty in funding becomes a concern, the importance to budget with the intention of different scenarios will help in decision making on the fly. With the growth in technology and software applications such as MS Excel, the capabilities of these software applications are typically grossly underutilized by users and can be very effective in the dynamic budgeting process. Creating worst, stable, and best case scenario budget models can help the fiscal management of your organization pivot and be ready to make impactful changes to hedge any negative outcomes of an economic downturn. Include trigger points or benchmarks that would need to be met for management to determine when to switch to and implement one of the established and pre-approved budget scenarios.

Budgets in today's economic environment need to be fluid and not as concrete as what budgets once were. As we saw, and continue to see, during the Covid-19 pandemic, when businesses were shuttered by the closedowns, economic opportunity came in the form of government spending, grants, and programs such as the PPP, ERC, and other Cares Act funding which your organization may have been able to take advantage of. Budgets needed to be updated quickly to factor in this funding and set any contingencies necessary to spread the use of these funds out to minimize impact in the future once CARES Act funding dried up. This is just one example that all businesses had to deal with because at the beginning of 2020, budgets were set with no real thought of having a world-wide shut down of the economy.

DEFINE YOUR INPUTS

In creating your budget, hopefully through some easily manipulatable format using excel, google sheets, or something comparable, it is important to define the inputs of your budget. Such inputs could be projected number of consumers, percentage increase or decrease in funding, percentage increase of salaries to employees, etc. These inputs should be linked to your overall budget to determine the impact of the major areas of the budget. When the inputs change throughout the year, so should your budget to be able to analyze the overall impact at any time. The various programs or segments should be regularly providing real time statistics to fiscal management which overall drive revenue and expenses. CFOs and top-level management need to understand the inputs, the regulations surrounding their funding streams, and the fiscal impact and they need to act like a emergency room doctor or nurse, constantly measuring the vitals of the organization to constantly maintain the organization's fiscal strength.

QUARTERLY BUDGETING

Budget to actual should be monitored timely and accurately at least quarterly. However, during an economic downturn or other fiscal crisis (*i.e. significant drops in fee for service volume, decreased fundraising, stock market declines, etc.*) you should do this monthly and periodically check in with the management of each of the organization's segments to ensure everyone is on the same page. Technology has given programs and businesses the ability to obtain data in an instant, so now more than ever these tools should be implemented to gather the data necessary to compile an accurate update to budgetary numbers on a macro and micro basis for your organization. Setting percent thresholds of unexpected changes to line items and overall budget numbers should trigger flags to fiscal management which could lead to insight into trends in spending and allow for action to be taken if needed. Quarterly budgeting should also include a cash flow forecast of the short-term and long-term cash needs of the organization. Should something change in the budget, what are the cash flow impacts of that change, and how do we hedge that change so it does not negatively impact the organization fiscally.

Budgeting in an economic downturn can be difficult, but with the right tools in place it can reduce the stress and burden on fiscal management to make impactful timely decisions by using a dynamic budgeting style that includes, scenario budgeting, clearly defining the inputs that drive your organization and how they impact your bottom line, and regular quarterly or more frequent budgeting. If the past 2 years have shown us anything, it is that sometimes we need to be at the ready to pivot and continue marching forward to a better tomorrow. For businesses, especially not-for-profits the uncertainty has led to organizations having to be more creative and emphasize the importance of fiscal budgeting not just annually but throughout the year as well. Not-for-profits are a resilient bunch and have always figured out ways to be impactful through their missions. This same mindset should be implemented with respect to the budgeting process to ensure that your organization's fiscal strength matches your organizations programmatic outcomes.

ALBERT BORGHESE, CPA
MANAGER



NONPROFIT FINANCIAL ANALYSIS

Nonprofit organizations are misunderstood for many reasons, one of which is inherent to their predominant label: “*nonprofit*.” The word simply refers to an organization without profits, which is not entirely accurate. A clearer general term for a member of this sector would be “*tax exempt organization*,” since the organization would be exempt from paying income taxes. Therein lies the real distinction. For-profit companies must pay income taxes on their profits while nonprofit companies do not. Of course, that doesn’t then preclude nonprofits from generating profits. It gets confusing and sounds wrong, but it’s not. From a fiscal perspective, well run nonprofit organizations function as any other business enterprises do, and yes, they should strive to generate profits. Understanding the nuances of nonprofit finances is essential to leading, managing, and assessing the effectiveness and viability of any organization. From the profit conundrum to liquidity, and from solvency to mission, stakeholders of nonprofit organizations are often left scratching their heads when reading nonprofit financial reports, statements, and tax filings. *What positive benchmarks should you look for? What are donors focusing on? Does anybody really care?* These are some of the many questions that we hope to answer by shining a light on the subjects that should matter most to readers of nonprofit financial information.

STANDARD NONPROFIT FINANCIAL REPORTS

The accounting gods force us to apply different terminology to nonprofits than we do other business enterprises, adding to the pile of confusion that the users of nonprofit financial statement already face. For-profit companies report their asset and liability balances at points in time in balance sheets. Nonprofits call them statements of financial position. For-profits hold shareholder’s equity for the part of assets that are not obligated. Nonprofit equity is called net assets. For-profit companies report their income, expenses, and net income (*profits*) on income or profit and loss statements. Nonprofits use statements of activities. Nonprofits also include a statement that for-profits do not; statements of functional expenses, which present costs between programmatic and other supporting categories. Statements of cash flows are the same, as are notes to financial statements, of course considering the unique quirks of individual businesses and industries. Tax returns for nonprofits (*IRS Form 990 and related state filings*) are more voluminous in nature, requiring significant programmatic, governance, and other supplemental information that for-profit tax filings do not require.

TO PROFIT OR NOT TO PROFIT?

There are two major schools of thought that differ in their views of what financial pictures nonprofits should aim to present to the outside world. To some, nonprofits should appear to need funds, not too financially sound, and with breakeven or worse operating results (*no profits*). While these are certainly valid considerations, they do not factor in all the practical considerations that are important to nonprofits. Nonprofits are businesses too. While their missions are altruistic, without positive financial results and positioning, nonprofits’ abilities to serve their constituents will be severely hampered. It’s difficult to deliver quality services, meet demands, scale, and evolve without adequate financial resources. It’s also challenging to convince donors, government agencies, and foundations to invest in nonprofit missions if the nonprofits themselves lack infrastructure and support. Nonprofits should not shy away from positive operating results, reserves, cash flow, and dare we say it, profits.

LIQUIDITY AND SOLVENCY

Liquidity measures an organization’s ability to meet its financial obligations as they come due in the next year of operations. There are many different calculations used to measure this, including working capital, current ratio, quick ratio, and days in cash. All these benchmarks intend to quickly judge an organization’s short-term solvency. Calculations and standard benchmarks are shown below:

- ▶ **Working capital** – *current assets minus current liabilities. Value should be positive. The higher, the better.*
- ▶ **Current ratio** – *current assets divided by current liabilities. Value should be at least 1.50. The higher, the better.*
- ▶ **Quick ratio** – *current assets convertible to cash within ninety days divided by current liabilities. Value should be at least 1.0. The higher, the better.*
- ▶ **Days in cash** – *The number of days the organization can operate with its cash balance as of a specific date based on an assumed daily cash “burn rate.” The higher, the better, but 60-90 days is healthy minimum.*

The word “*current*” refers to assets that can be liquidated or expected to convert to cash within one year (*cash, receivables, investments, prepaid expenses, et al*) and/or liabilities that are required to be paid within one year (*vendor payables, employee payables, debts maturing within one year, lease obligations, et al*).

Poor liquidity measures may cause organizations to delay payments to vendors, struggle to meet payroll obligations, constrain program activity, seek new debt financing, delay capital expenditures, and prevent investment in expansion, none of which help to serve underlying missions.

To consider overall solvency, liquidity certainly plays a role, but noncurrent assets and liabilities need to be factored in as well. Remember that net assets are akin to equity. Positive net assets are an essential financial metric for any solvent nonprofit organization. This bluntly reports that an organization’s assets exceed its liabilities. Special attention must be placed on the underlying nature of net assets though. Nonprofits with significant donor restrictions may appear fiscally sound on the surface, but they may be hamstrung in reality. Nonprofits thus need to ensure that their net assets without donor restrictions balances are always positive. Negative balances are red flags. Similarly, net asset balances that are composed of illiquid assets, such as property and equipment, are less useful than more liquid assets. That should be contemplated when forming any conclusions on nonprofits’ solvencies.

FINANCIAL AND PROGRAM PERFORMANCE

Nonprofits generate revenue from so many sources – donations, government support, events, programs, investments, and more. They spend money in so many ways as well – payroll, occupancy, technology, marketing, and many others. Statements of activities compare all revenue and all expenses to arrive at organizations’ changes in net assets (*this is net income for for-profit companies*). This is where profit comes into play. The higher the change in net assets, the better. Trends over time should also be positive. Wild fluctuations from one year to the next are common for nonprofits, but not ideal. Smooth, consistent growth in total revenue and total expenses, along with changes in net assets, are signs of well-managed and successful organizations. Another way to assess an organization’s ongoing financial performance is to normalize its revenue by removing nonoperating items, such as loan forgiveness, investment gains, and other one-time items. If an organization can pay its total expenses with its normal program revenue and support, then it’s well-structured and fiscally sound. Programmatically, an organization’s program service percentage continues to be an important metric used almost universally. This represent the portion of total expenses that are on program services. Benchmarks vary depending on the type of organization and funding sources, but most tend to fall in the 70-90% range. A figure much below that, without reasonable explanation, should give reason to pause. Generally speaking, the higher this ratio is, the better it is viewed by third parties, such as donors.

IN CLOSING

One must remember that all nonprofits cannot be painted with the same brush. There are different subsectors within the nonprofit world that will showcase different financial characteristics. The information above is meant to be generic and to start conversations/analyses, not necessarily finish them. There are countless other matters, facts, and figures that can and should be weighed when assessing any nonprofit’s financial wherewithal and execution. Being well armed with proper context, expectations, and background is essential for nonprofit leaders. We will soon be hosting a series of webinars to explore this subject more fully with nonprofit stakeholders. Stay tuned and stay connected to us.



MATTHEW BURKE, CPA, CFE
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UNDERWATER ENDOWMENTS

If you have been following the stock market, you know that the stock market is having one of its worst years in more than 50 years. With portfolios heading down, many nonprofit organizations are seeing declines in their investments and endowments, which could open up certain concerns from both an accounting and a legal perspective.

From a legal perspective, you have the **New York Prudent Management of Institutional Funds Act (“NYPMIFA”)**, which strives to promote a total return approach to spending, similar to that of the total return approach to investing. NYPMIFA supports investing at a rate that will preserve the purchasing power of the principal over the long-term, while spending at a rate that will reflect the donor’s intentions. NYPMIFA requires a nonprofit’s Board to develop formal spending and investment policies, and also to review those policies on an annual basis. Additionally, there are eight factors for prudent managing and investing of an institutional fund outlined by NYPMIFA. Nonprofits are required to have a written policy describing how those standards have been adopted and how they are to be implemented in managing and investing the organization’s funds. In addition, on at least an annual basis, the Board must review its investments against certain factors specified within NYPMIFA to determine if the Board is meeting the NYPMIFA-imposed duty to manage and invest the fund in good faith and with the care an ordinarily prudent person in a like position would exercise under similar circumstances. This review must be documented and must consider the following if they are relevant:

- ▶ *General economic conditions*
- ▶ *The possible effect of inflation or deflation*
- ▶ *The expected tax consequences, if any, of investment decisions or strategies*
- ▶ *The role that each investment or course of action plays within the overall investment portfolio of the fund*
- ▶ *The expected total return from income and the appreciation of investments*
- ▶ *Other resources of the organization*
- ▶ *The needs of the organization and the fund to make distributions and to preserve capital*
- ▶ *An asset’s special relationship or special value, if any, to the purposes of the organization*

Contemporaneous Board minutes should reflect a careful review of each of these 8 factors. It is not sufficient to merely state that the Board reviewed the 8 factors, but rather, the minutes should detail the substantive consideration given to each factor by the Board. If any of the factors was determined not to be relevant, the basis for that determination should be included in the minutes. The fund must be diversified, unless the institution prudently determines that, because of special circumstances, the purposes of the fund are better served without diversification. NYPMIFA places a spotlight on a decision not to diversify by providing that an organization shall review a decision not to diversify as frequently as circumstances require, but at least annually.

With the downturn in the economy, the significant decline in investments, and the dramatic increase in inflation, changes in investment strategies may be warranted in order to remain prudent stewards of organizational investments.

From an endowment perspective, donor intent is the deciding factor on how endowment funds can be utilized. A donor can either provide that the corpus be held in perpetuity and some or all of the investment income can be used, or that a set amount of the funds be spent, regardless of the value of the corpus (*this is quite common with respect to scholarship funds*).

If the donor is silent as to how an endowment should be utilized, and only if the organization complies with the mandatory technical and procedural requirements of NYPMIFA, NYPMIFA provides the organization’s Board with the ability to make the decision as to how the endowment funds will be utilized – subject always to NYPMIFA’s prudence standard. The mandatory technical and procedural requirements of NYPMIFA that must be complied with include a specific form of notice to donors allowing them to opt in or out of NYPMIFA’s spending provisions if the gift instrument was executed before September 17, 2010.

With two different methodologies in place, each having a significantly different way funds can be expended, especially when an endowment is underwater (*asset value is lower than the original contribution amount*), it is important to ensure that endowment strategies are properly documented.

In a situation where an endowment is underwater and the fund is required to be held in perpetuity, with the preservation of the corpus of the endowment required to be maintained, none of the endowment will be able to be distributed. This could leave a hole in an organization’s budget. Conversely, where an endowment allows for part of the corpus to be spent, payments from the endowment can be made, albeit it at potentially lower levels than normal due to the decline in the balance of the endowment. The amount that can be spent will be based upon the spending policy the organization has put in place and the provisions, rules, processes and procedures within NYPMIFA (*including the prudence standard*).

Note that NYPMIFA contains a provision that creates a rebuttable presumption of imprudence if an organization appropriates more than a specified percentage of a fund’s fair market value. This rebuttable presumption of imprudence does not apply to appropriations permitted under law or under the gift instrument, nor does it create a presumption of prudence for a lesser appropriation for expenditure.

From an accounting perspective, any declines in the value of a permanent endowment will be reflected as a loss within the endowment balance and the related net assets with donor restrictions.

In order to expend endowed funds, the Board of Directors must decide whether they are going to “*accumulate*” (*leave the funds in the endowment as part of the permanent endowment*) or “*appropriate*” (*designate the funds for use either immediately or in the future*) such funds. Appropriated funds remain restricted until such time as they are expended.

In deciding whether to appropriate or accumulate from an endowment fund, the organization must act in good faith, with the care that an ordinarily prudent person in a like position would exercise under similar circumstances, and must consider, if relevant, the following factors:

- ▶ *The duration and preservation of the endowment fund*
- ▶ *The purposes of the organization and the endowment fund*
- ▶ *General economic conditions*
- ▶ *The possible effect of inflation or deflation*
- ▶ *The expected total return from income and the appreciation of investments*
- ▶ *Other resources of the institution*
- ▶ *Where appropriate and circumstances would otherwise warrant, alternatives to expenditure of the endowment fund, giving due consideration to the effect that such alternatives may have on the institution*
- ▶ *The investment policy of the organization*

Similarly, to its investment policy, a nonprofit organization needs careful review and documentation of its decision to appropriate or accumulate endowment funds (*whether in a down economy or otherwise*) to ensure that it is following NYPMIFA regulations, as an endowment, by its very nature, is meant to have a long-term benefit to the organization and those it serves. Here too, contemporaneous Board minutes should reflect a careful review of each of these 8 factors. It is not sufficient to merely state that the Board reviewed the 8 factors, but rather, the minutes should detail the substantive consideration given to each factor by the Board. If any of the factors was determined not to be relevant, the basis for that determination should be included in the minutes. The Board of Directors has a fiduciary responsibility to ensure that its resources are being prudently invested and expended. NYPMIFA provides a statutory framework to ensure that this is being appropriately done. Organizations and their Boards should take the time to understand NYPMIFA and its impact, especially in a down market where there will be a greater level of need, and likely a greater level of scrutiny.



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