A listing of, and discussion of, some of the differences between Non-Profit companies and For-Profit companies, with a focus on governance issues, accounting treatment (FASB's) and related issues

Many folks, like me, have spent most of their careers working in the For-Profit world. Then, again like me, as their twilight years approach, they find they are not ready for retirement; they still have plenty of energy. They've had significant exposure to Non-Profits because they've been on several of these Boards. They've come to realize that many Non-Profits have a significant need for sophisticated business and financial management. This has been my experience. For those considering a similar transition, a listing of, and discussion of, some of the differences between these two worlds, might be useful. That is the purpose of this article.

<u>Terminology obfuscates business reality</u>

The term 'non-profit' is a poor choice of term for a 501c3 corporation. Why? Because it suggests that the 501c3 corporation does not need to make a profit. The reality is that 'non-profit' corporations need to make a profit just like 'for profit' corporations. If a non-profit corporation doesn't make a profit, it will, at some point, go out of business, in exactly the way a for-profit business will. That is, it will ultimately run out of cash, not be able to service its debt or pay its creditors, and be forced to close its doors.

A non-profit corporation, unlike a for-profit corporation, does <u>not</u>, by virtue of its 501c3 exemption, have to pay a tax on its profits. This distinction should not be allowed to cloud the underlying business reality.

Non-profits use other terms that, in my humble opinion, are equally obfuscatory. For example, in the non-profit lexicon, a profit is described as a surplus; a loss is described as a deficit; a Balance Sheet is described as 'a Statement of Financial Position'; a P&L Statement is described as 'a Statement of Activities'. All of these terms are to an extent slightly misleading, because they can easily disguise the reality of what is going on with the business. Each year a non-profit business incurs a deficit (a loss), its Net Assets (Equity or Net Worth in ordinary parlance) are eroded by the amount of that deficit. This normally has the effect of reducing its cash reserves, along with its ability to borrow money.

While it's true that non-profits tend to have a broader mission than for-profit businesses – non-profits have to have a socially desirable mission (e.g. treating alcohol and drug addiction, providing services for those with disabilities, helping low income folks obtain housing, improving educational outcomes in underserved communities, to name just a few) in order to obtain their 501c3 exemption – nevertheless non-profits are subject to exactly the same economics as for-profit businesses. Chronic losses/deficits will ultimately force them out of business.

Accordingly, in the non-profit organizations I work with, we use the regular terminology – profits, losses, Balance Sheet, P&L – to ensure that no one in the organization can easily delude themselves into thinking that making a profit isn't an important ongoing imperative. This does not derogate from the importance of the non-profit's mission (or what is described on the IRS Form 1023 – the form filed with the IRS to obtain a 501c3 exemption – as the 'purpose'); in fact, it enhances its mission because by operating in a financially sustainable fashion (i.e. profitably), the organization's longevity is assured.

<u>Accountability Disconnect</u>

In a for-profit company there is, at least in theory, a continuous chain of accountability. Employees report to their manager; the managers report to the CEO; the CEO reports to the Board; and the Board is elected by and reports to the owners/shareholders/equity holders of the company. In a non-profit, however, there is no equity, or ownership per se. This creates a disconnect in the normal chain of accountability. The Directors, at least initially, rather than selecting the senior management, are selected by the senior management. After initial appointment to the Board, the Bylaws normally provide an ongoing Director appointment/election process. The practical reality of this is that the organization's senior management are usually intimately involved in who becomes a Board member. Those Board members are then, at least in theory, expected to have the Executive Director/CEO report to the Board on an ongoing basis. Put another way, the normally continuous and linear chain of accountability suddenly becomes somewhat circular.

The result of this 'inbuilt governance disconnect' is that non-profits tend to have more governance issues than comparably sized organizations in the for-profit world. Accordingly, carefully crafted Bylaws take on added importance, as do initiatives like periodic 'governance education' for senior management and Board members.

Net Assets, not Equity

A non-profit organization's Balance Sheet does not have an Equity section (consistent with the Accountability Disconnect section immediately above). In place of what would be an Equity section in the Balance Sheet, non-profits have a section entitled Net Assets. It operates in the same way as the Equity section in a for-profit business, except that, because non-profit's have no owners, there is no Paid In Capital, just Retained Earnings. Put another way, a for-profit business's Equity section of the Balance Sheet normally contains two sections – the 'contributed capital' section (e.g. Common Stock, Preferred Stock, Paid In Capital), and the 'retained earnings' section. The non-profit's Net Assets section, in contrast, contains only the 'retained earnings' section. These 'retained earnings' are normally divided into Restricted and Unrestricted Net Assets (this is the subject of a different discussion).

Reporting and Compliance

In a for-profit non-public company, reporting and compliance is usually confined to monthly financial reporting for the Board, annual Federal and State tax filings, debt covenant compliance, perhaps an annual audit and issuance of annual audited financials. Non-profits, which are often public charities, not only have to produce all the above reports and compliance, but the State and Federal tax filings (the 990) are significantly more extensive because they include reporting on governance issues e.g. conflicts of interest of officers and directors. If the non-profit receives more than $750,000 in Federal funds, they will generally have to conduct a more extensive annual audit (known variously as a 'single audit', or A-133 or UG). If the non-profit is a public charity then it can't earn more than a certain amount of earnings from its 'for-profit' business unrelated to its charitable mission, otherwise it becomes subject to UBIT (Unrelated Business Income Tax) taxes, and has to file a separate UBIT tax return (for more detail on this see http://www.berngalvin.com/wp-content/uploads/2021/04/everynonprofitstaxguide_nirs5.pdf).

Most grants received by non-profits come with at least annual compliance requirements. These can be extensive, depending on the size and nature of the grant, and frequently this compliance isn't closely related to the normal financial reporting performed by the non-profit. Put another way, for the non-profit to meet the compliance requirements of their grants, they may have to institute new or at least significantly more extensive accounting/tracking systems. This in turn has implications for the type of accounting software used by the non-profit. For example, QuickBooks is only 2 dimensional (the GL code and Classes), limiting its reporting capabilities significantly. Xero, an increasingly popular web-based accounting package, is 3 dimensional (GL codes and 2 Tracking codes), thus giving it a significant reporting advantage over QuickBooks (I often recommend and install this in smaller non-profit clients). Sage Intacct, also web-based software, which I recommend and install in larger non-profit clients (it has significantly higher license fees that Xero or QuickBooks), is 8 dimensional (and those dimensions can be custom configured), making it a vastly more capable tool where multiple grantor compliance is required.

<u>The FASB's</u>

The FASB (Financial Accounting Standards Board) rules governing non-profits are generally straight forward and what one might expect coming from the for-profit world……with one exception; non-profits are allowed to book Pledges (and thus Pledge Revenues) at the time the Pledge is made. Pledges are not a legally enforceable obligation. Consequently, many Pledges are made, resulting in the non-profit booking the Pledge Revenue, and then the Pledgor defaults on the Pledge (i.e. (s)he doesn't pay up). This means the non-profit has to write back the Pledge Revenue. It also means that a non-profit Balance Sheet can contain Receivables that are actually Pledges. My policy is not to book Pledges unless there is a very high comfort level that the Pledgor won't default. Further, when reviewing a non-profit's Balance Sheet, it is always prudent to ask whether it contains any Pledge type receivables. If it does, then depending on the comfort with the Pledgor, I would typically manually adjust the Pledge receivable out of Accounts Receivable and out of Revenues (in the P&L). Booking Pledges and then subsequently having to write them back because they were defaulted on, is not a way to build confidence in stakeholders (like donors and grantors) looking at the non-profits financials.

The non-profit FASB's do not require that the non-profit distinguish in their accounts between <u>repeatable</u> Revenues (what a for-profit entity would describe as Operating Revenues) and <u>one-time</u> Revenues. For example, if someone dies and bequeaths their favorite non-profit $1M in their will, this amount will simply be included as Revenues in the non-profit's P&L, along with all the repeatable Revenues of the non-profit. The deceased can only die once. Thus the $1M is a one-time non-repeating event. If it is included/commingled/reported in Revenues, it tends to give a deceptive impression of the non-profit's (repeatable) operating performance for the year. If it were a for-profit, this $1M would have to be classified as an Extraordinary Item, <u>not</u> part of Operating Revenues.

<u>Non-profit Board Members</u>

Most non-profit Board members serve on a voluntary basis. Consequently, non-profit Directors often have little idea of their fiduciary obligations; and frequently these Directors have no real reason for being on the Board. Too often they are on the Board because they are friendly with the Executive Director. Sometimes there is an understanding that they will 'rubber stamp' initiatives brought before the Board by the Executive Director (it was after all the Executive Director who got them appointed to the Board). Often the Board is a 'Good Old Boys' club, who meet periodically, and aren't focused on what is actually in the best interests of the entity which they govern. Too many people serve on non-profit Board for ego reasons, or to appropriately supplement their resumes.

The non-profit sector comprises a significant segment of the California economy, primarily because social safety nets typical in other western economies tend to be much smaller, or even non-existent, here; requiring non-profits to step in and fill the void. Non-profits thus perform important societal responsibilities, that might not otherwise be adequately discharged. There is a great need for Directors who are educated in their fiduciary obligations; serious about performing them, and who bring professional skills to the Board they serve on. Being passionate about the non-profit's mission is not enough.

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