

# Financial Literacy and Knowledge in the Nonprofit Sector



THE MOODY'S FOUNDATION

A report researched and written by



February  
2012

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**We especially thank Indiana University's Center for Survey Research in  
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# Executive Summary

Financial literacy and knowledge play a vital role in the creation and sustainability of a vibrant nonprofit sector, particularly in the current economic environment. For the past two decades, a growing wealth of economic and financial data has become available to help inform effective decision-making within the nonprofit sector. It has become increasingly important for nonprofit organizations to have the knowledge and skills that are necessary to apply and use this data for decision-making and benchmarking. However, little is known about the current state of financial literacy and knowledge at nonprofit organizations. One major purpose of this study is to fill this gap by investigating nonprofit organizations' financial literacy and knowledge and exploring how such knowledge informs their practices.

The *2011 Financial Literacy and Knowledge in the Nonprofit Sector* report offers new insights on the resources nonprofit organizations use to manage their finances, identifies best practices in financial decision-making, and provides suggestions for improving financial planning in the long term. Conducted by the Center on Philanthropy, in collaboration with The Moody's Foundation, this study seeks to better understand nonprofit organizations' financial literacy and knowledge as well as the financial practices these organizations currently adopt. A composite definition of financial literacy is: *The knowledge and skills of basic economic and financial concepts, as well as the ability to apply this knowledge in order to manage financial resources effectively.*<sup>i</sup>

This study reflects the responses of more than 500 nonprofit professionals who are most responsible for their organization's overall financial management (please see Methodology section for more information). The following is a summary of the key findings from the study.

## **Different levels of financial literacy and knowledge in nonprofit sector**

- Approximately 76 percent of respondents consider themselves to be knowledgeable in financial principles and concepts, while 17 percent reported that they are novices in terms of their level of financial knowledge. Only 6.9 percent consider themselves to be experts.
- To create a measure of financial literacy, respondents were asked three questions covering bond prices and interest rates, investment risk, and diversification. More than one-third of respondents (36.4 percent) were able to answer all three questions correctly and about 32 percent answered two questions correctly. There were several differences in financial literacy when compared by different characteristics.
  - Financial literacy increased with the number of courses taken in accounting, economics, operations, and financial management. Nearly 50 percent of respondents who had taken five or more courses answered all three questions correctly compared to 37.4 percent of respondents who had taken only one or two classes. Nearly 35 percent of respondents who had taken no coursework in accounting, economics, operations, or financial management answered all three questions correctly.
  - When examined across various organizational revenue categories, financial literacy increases as organizational revenue increases. Nearly 45 percent of

organizations with revenues of \$5 million or more answered all three questions correctly compared to 26.4 percent of organizations with a revenue size of less than \$1 million.

- In exploring financial literacy by the gender of the respondent, findings show that male respondents are statistically significantly more likely to answer all three questions correctly (49.8 percent) compared to female respondents (39.3 percent).
- This study found that respondents had varying levels of knowledge of financial principles and procedures, which demonstrates areas for growth or education:
  - Financial management systems & controls (80.1 percent)
  - Cash flow projections (75.3 percent)
  - Reporting internal policies to employees (74.4 percent)
  - Financial scenario planning (72.1 percent)
  - Debt restructuring (46.2 percent)
  - Collaboration or merger analysis (41.7 percent)

### **Indicators underutilized for financial decision-making**

- In an ideal situation, robust, timely, and accurate information would flow easily to nonprofits, donors, and intermediaries, supporting decision-making. While nonprofits have made progress in recent years, there is still much room for improvement. Nonprofit organizations use the following indicators in financial decision-making:
  - Changes or forecasts in charitable giving (84.4 percent)
  - Changes or forecasts in charitable giving by subsector (71.4 percent)
  - Inflation rates (72.5 percent)
  - Poverty rates (43.5 percent)
  - Unemployment rates (51.6 percent)
  - S&P 500 Index or other stock indices (47.4 percent)
  - Tax rates (36.1 percent)

### **Gaps in board education and involvement in financial management**

- Financial oversight and fundraising are among the most common expectations for nonprofit boards' responsibilities, but there is relatively little empirical literature examining the financial responsibilities of nonprofit boards in detail. Board members receive the following materials during an orientation:
  - Information on board member role and responsibilities (97.2 percent)
  - Ethics policies, such as conflict of interest, and whistleblower (93.2 percent)
  - Audited financial statements (88.7 percent)
  - Most recent Form 990 (74.2 percent)
  - Financial risk management procedures (63.8 percent)
- Organizations reported that their board was very involved in carrying out financial functions, such as:
  - Financial accountability (66.3 percent)
  - Internal audit and risk management (42.7 percent)

- Investment management (38.2 percent)
  - Budget development (29.7 percent)
  - Fundraising (26.8 percent)
  - Debt restructuring (26.8 percent)
  - Financial scenario planning (26.5 percent)
- The presence of monitoring mechanisms, such as audit committees, has been recognized as a means of improving accountability of nonprofit organizations. Only 39.3 percent of organizations had an audit committee. The majority, 60.7 percent, did not have an audit committee.

### **Planning ahead, creating policies and procedures for financial management**

- This study found that striving to meet an appropriate liquidity target over time – that is, maintaining a targeted level of cash reserves and financial flexibility (37.6 percent) and assuring an annual surplus so the mission can be achieved in down years (26.6 percent) – are the top two primary financial objectives for the organization. An additional 23.7 percent reported that breaking even financially was a primary financial objective for the organization.
- Nearly 49 percent of organizations had less than three months' worth of operating expenses available for seasonal imbalances where cash outflows exceed cash inflows. One quarter of organizations (26.4 percent) had four to six months of operating expenses available, and an additional quarter had more than seven months of operating expenses available in cash.
- About 80 percent of organizations reported having a fiscal policies and procedures manual, which outlines financial and accounting policies and procedures for staff, and documents internal controls for the organization. More than three-quarters (77.4 percent) of organizations had a board-approved spending policy regarding operating expenses to be paid from endowment principal or earnings. Two-thirds (66.2 percent) of organizations had a board-approved spending policy regarding capital expenses to be paid from endowment principal or earnings.

With the recent economic downturn, many nonprofit organizations are facing unprecedented hardships as financial resources and funding are being cut or have become increasingly scarce. The recovery of these nonprofit organizations will rely on the ability of managers and board members to understand basic financial and economic principles, and to put that understanding into practice. Managers and board members will have to demonstrate a high level of financial literacy in order to establish a sustainable long-term financial plan, secure income, maintain a healthy cash balance, and minimize risk in order to provide the essential services and support that fulfill their core mission values.

## Reading this Report

This report is divided into four sections:

- 1. Financial Knowledge and Literacy.** This section covers respondents' reported level of financial knowledge, response to statements on financial principles, and level of expertise with various financial management principles/tools.
- 2. Use of Indicators.** The purpose of this section is to gather information on the indicators that organizations use before making programmatic or financial decisions.
- 3. Board Role and Governance.** This section is focused exclusively on the board's role and involvement within the organization's governance.
- 4. Financial Management: Controls and Procedures.** This section explores how organizations effectively prepare and utilize multiple financial and strategic plans to maintain the financial well-being of the organization.

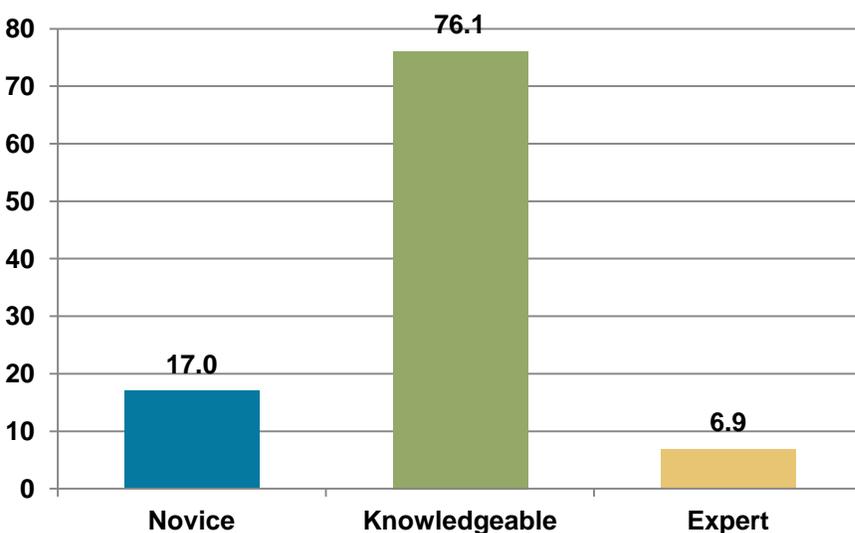
# I. Financial Knowledge and Literacy

To make sound financial decisions, nonprofits need to be equipped not only with a basic level of financial knowledge, but also with the skills to apply what they know to actual financial decision-making situations.

## Self-reported Knowledge of Financial Management

The majority of respondents, 76.1 percent, consider themselves knowledgeable in financial principles and concepts, while 17 percent reported that they are novices in terms of their level of financial knowledge. Only 6.9 percent of respondents consider themselves to be experts regarding financial principles and concepts (see Figure 1).

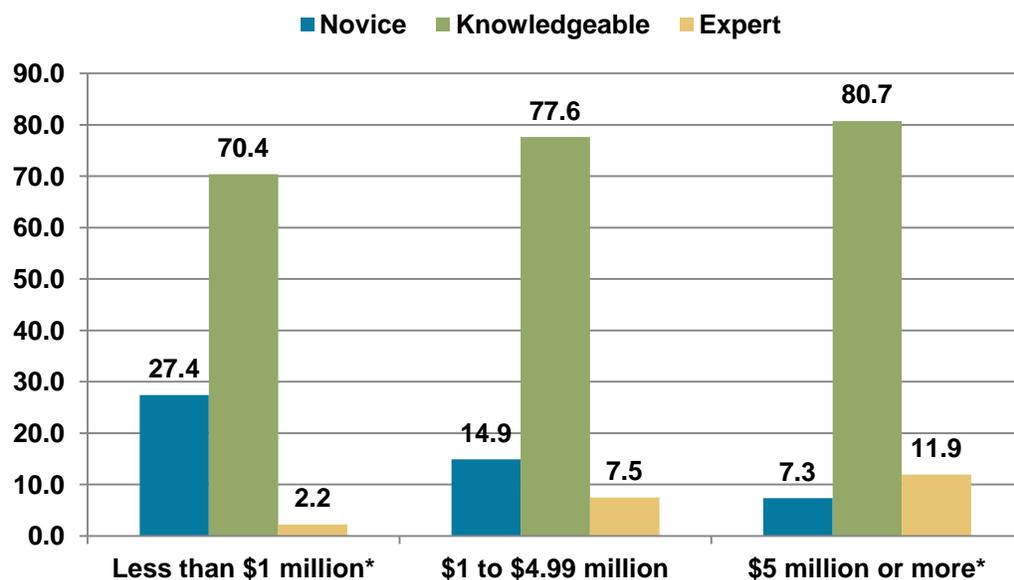
**Figure 1: Respondents Reporting Knowledge of Financial Management (%)**



## Self-reported Knowledge of Financial Management, by Organizational Revenue

In Figure 2, most organizations consider themselves knowledgeable in financial principles and concepts. Nearly 81 percent of organizations with revenues of \$5 million or more consider themselves to be knowledgeable in financial management, while about 70 percent of organizations with revenues of less than \$1 million consider themselves knowledgeable in these areas. Moreover, organizations with smaller revenues are statistically significant to report that they are novices in terms of their level of financial knowledge (27.4 percent for organizations with revenues of less than \$1 million, and 7.3 percent for organizations with revenues of \$5 million or more). Even among large organizations (with revenues of \$5 million or more), only 12 percent consider themselves experts in financial principles and concepts.

**Figure 2: Respondents Reporting Knowledge of Financial Management by Organizational Revenue (%)**



Note: \*Statistically significant at the 5% level. Organizations with revenues of less than \$1 million are significantly more likely to report they are novices, while organizations with revenues of \$5 million or above are significantly more likely to report they are experts.

### Why is financial literacy important to nonprofit organizations?

Over the past several decades, the financial world has become increasingly sophisticated and complex. Not only must nonprofits take greater charge of their financial well-being, but they must also forecast future financial needs, navigate economic instability, and manage risk. Nonprofits will need to be armed with the right financial skills, knowledge, and products to make sound financial decisions. Financial and economic literacy play a vital role in the creation and sustainability of a vibrant nonprofit sector, particularly during a time of limited resources.

## Measuring Financial Literacy

Respondents were given three statements and were asked to respond if they were true or false.

- *If interest rates rise, bond prices will rise.*
- *When an investor spreads money between 20 stocks, rather than 2, the risk of losing a lot of money increases.*
- *Buying a single company's stock usually provides a safer return than a stock mutual fund.*

These questions reflect fundamental concepts related to economics and finance such as the relationship between bond prices and interest rates, investment risk, and diversification, and are often used to evaluate the understanding of basic financial principles.

In Table I below, respondents showed strong levels of financial understanding for questions regarding investment risk and diversification. Over 80 percent of those surveyed gave the correct answer for these two questions while less than 4 percent answered incorrectly. Between 11 and 14 percent of respondents did not know the answers to these two questions about risk and diversification.

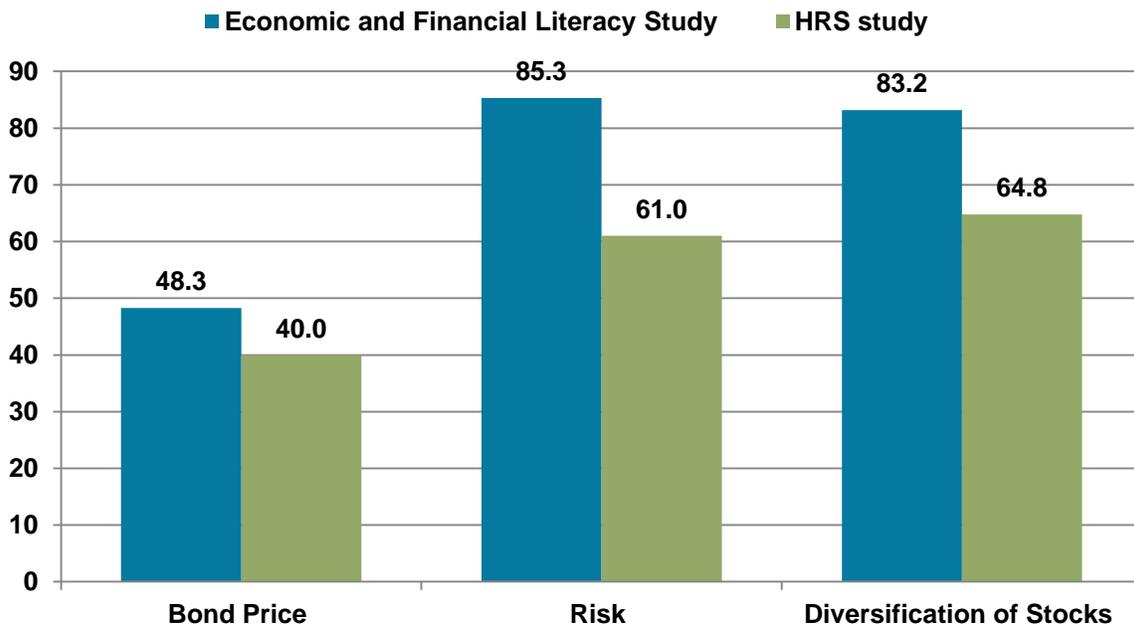
However, respondents demonstrated a relatively low level of understanding regarding bonds and interests rates, as less than half (48.3 percent) gave the correct answer, while nearly a third (28 percent) did not know the answer to the bond price question. More than one-third of respondents (36.4 percent) were able to answer all three questions correctly and about 32 percent answered two questions correctly.

**Table I: Respondents Reporting Understanding of Bond Prices, Investment Risk, and Diversification of Stocks (%)**

Question	Correct	Not Correct	Don't Know
Bond Price/Interest Rate Question	48.3	23.7	28
Investment Risk Question	85.3	3.6	11.1
Diversification of Stocks Question	83.2	2.6	14.2

Respondents to this survey were more likely to answer all three questions correctly when compared to a national sample from the 2008 Health and Retirement Survey (HRS). As shown in Figure 3, more than 85 percent of respondents to this study answered the risk question correctly, compared to 61 percent from the HRS study. Only 48.3 percent of respondents to this study and 40 percent of respondents to the HRS study had some knowledge of more complex concepts, such as the relationship between bond prices and interest rates. About 83 percent of respondents to this study answered the diversification of stocks question correctly, compared to 64.8 percent from the HRS study.

**Figure 3: Percentage of Respondents Who Answered Each of the Three Questions Correctly, Compared to HRS Study (%)**

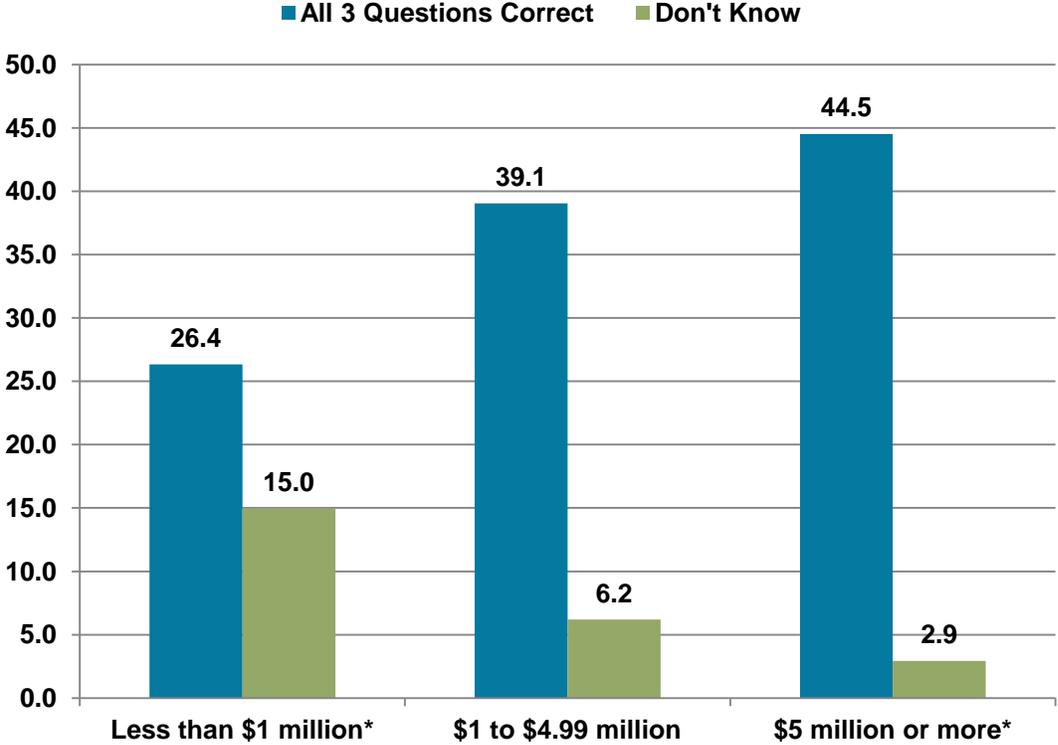


The HRS is a longitudinal study that surveys over 22,000 people over the age of 50 every two years and is supported by the National Institute on Aging and the Social Security Administration. For more information, go to: <http://hrsonline.isr.umich.edu/>.

# Financial Literacy by Organizational Revenue

Approximately 45 percent of large organizations (with revenues of \$5 million or more) answered all three questions correctly, and only 3 percent did not know the answer to all three questions. For organizations with revenues of less than \$1 million, about 26 percent answered all three questions correctly and 15 percent did not know the answer to all three questions. These differences are statistically significant.

**Figure 4: Financial Literacy by Organizational Revenue (%)**



Note: \*Statistically significant at the 5% level. Organizations with revenues of less than \$1 million are significantly more likely to report that they did not know the answer to all three questions, while organizations with revenues of \$5 million or above are significantly more likely to have answered all three questions correctly.

In Table II below, financial literacy is compared by organizational revenue, subsector of the organization, length of employment of the respondent at the organization, courses in economics or finance, and gender.

Financial literacy increases as the organizational revenue increases. About 45 percent of respondents from organizations with annual revenue of \$5 million or more answered all three questions correctly, compared to only 26.4 percent of respondents from organizations with annual revenues of less than \$1 million. These differences were found to be statistically significant. Conversely, the percentage who answered “don’t know” for all three questions decreased as the organizational revenue increased.

Examining financial literacy by length of employment at the organization, findings show that 46.5 percent of those employed more than 10 years at the organization answered all three questions correctly compared to 42 percent who were employed less than five years at the organization. However, these percentages failed to be statistically significant. Respondents seemed to perform similarly regardless of their length of tenure at the organization.

Financial literacy increased significantly when the number of courses taken in accounting, economics, and financial management increased. Nearly 50 percent of respondents who had taken five or more courses answered all three questions correctly compared to 37.4 percent of respondents who had taken only one or two classes. Over half (56.5 percent) of those who had taken more than five courses answered the bond question correctly, while only 35 percent of respondents who had taken no coursework answered all three questions correctly.

Male respondents are statistically significantly more likely to answer all three questions correctly (49.8 percent) compared to female respondents (39.3 percent), and men are also significantly less likely to answer “don’t know” to all three questions.

**Table II: Financial Literacy by Various Characteristics (%)**

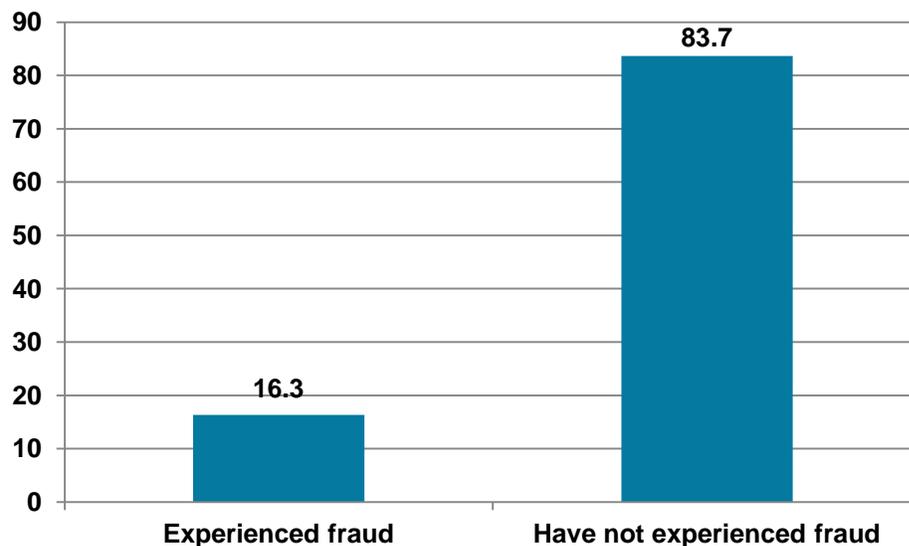
	Percentage who answered:				
	Bond question correctly	All three questions correctly	Two questions correctly	One question correctly	Answered “don’t know” to all three questions
<b>Organizational revenue</b>					
• Less than \$1 million	36.6**	26.4**	17.4	1.2	15.0**
• \$1 million to \$4.99 million	50.6	39.1	19.5	1.4	6.2
• \$5 million or more	59.0**	44.5**	19	2.2	2.9**
<b>Years of employment</b>					
• Less than five years	47.7	42.0	26	2.3	10.7
• Five to ten years	47.0	42.4	22	1.5	8.3
• More than ten years	50	46.5	20.8	1.9	10.1
<b>Number of courses in economics/finance</b>					
• None	34.8**	34.8	13	2.2	10.9
• One to two courses	37.4	37.4	25.2	2	12.1
• Three to four courses	47.8	40.0	24.3	1.4	8.6
• More than five courses	56.5**	49.8**	22.7	2	8.9
<b>Gender</b>					
• Male	55**	49.7**	26.1	1.9	5.7**
• Female	41.8**	38.3**	19.6	1.9	13.9**
<b>Subsector</b>					
• Health/Human Services	51.1	38.7	17.3	2.1	8.2
• Others	42.9	31.8	21.4	0.6	8.1

\*\*Statistically significant at the 5% significance level

## Fraud and Key Reasons for Its Occurrence

Respondents were also asked whether or not their organization had ever been a victim of fraud. The majority (83.7 percent) stated that they had never been a victim while less than one fifth of respondents (16.3 percent) stated that they had.

**Figure 5: Percentage of Respondents Indicating Their Organization Had Experienced Fraud (%)**



For those respondents who indicated they had been victims of fraud, we asked them, to the best of their knowledge, about key reasons for the fraud occurring. Nearly half (49.3 percent) mentioned lack of proper oversight and control procedures in place as a reason for fraud occurring. About one fifth (19.2 percent) mentioned falsification of their organization's financial statements, and following closely behind was misappropriation of assets (16.4 percent). The remaining respondents mentioned a compromised organization bank account or credit card, or other reasons (9.6 and 5.5 percent, respectively).

## Making the Shift from Financial Literacy to Financial Capability

Even though the majority of nonprofit managers in this study had taken on average three to four accounting, economics, operations, and financial management courses in their education, this information may lie dormant in the minds of individuals until much later in life when they have sufficient resources to utilize what they have learned. In this situation, a course in financial management or economics may not have an immediate impact on financial literacy until the knowledge is actually applied. Financially capable managers plan ahead, find and use information, know when to seek advice and can understand and act on this advice, leading to greater participation in the financial well-being of the organization.

## Operating Reserve

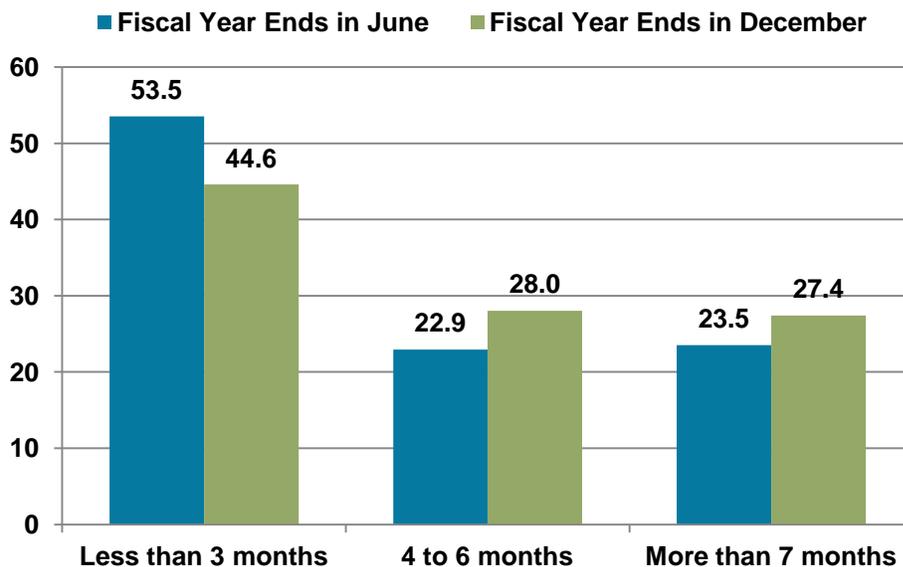
An operating reserve is an unrestricted fund balance set aside to stabilize a nonprofit's finances by providing a "rainy day savings account" for unexpected cash flow shortages, expenses or losses. These might be caused by delayed income payments, unexpected building repairs, or economic conditions.



A commonly used reserve goal is 3-6 months' expenses. At the high end, reserves should not exceed the amount of two years' budget. At the low end, reserves should be enough to cover at least one full payroll. However, each nonprofit should set its own reserve goal based on its cash flow and expenses. To be a viable operating reserve, there should be a board agreement and policy about how reserve funds can be used: When they can be used, who is authorized to use them, and how this is reported to the board.

Over half of organizations with fiscal year ending in June in the survey (53.5 percent) had less than 3 months' worth of operating expenses available in cash or easily convertible assets as of September 2010, and nearly 45 percent of organizations with fiscal year ending in December reported the same. Less than 30 percent of all organizations reported having between 4 and 6 months of operating expenses available (23 percent and 28 percent for organizations with fiscal year ending in June and December, respectively). Similar patterns are found for organizations reporting having more than 7 months of operating expenses available (see Figure 6).

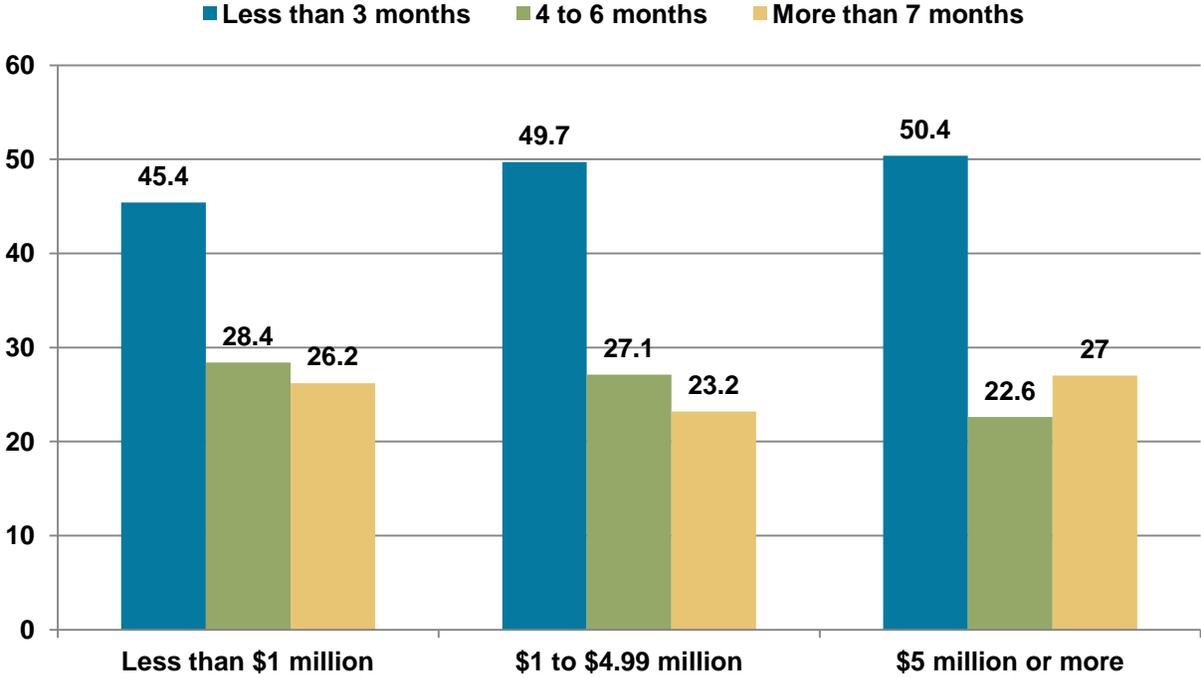
**Figure 6: Percentage of Respondents Reporting Number of Months of Operating Expenses Available (%)**



*Number of Months of Operating Expenses Available, by Organizational Revenue*

When comparing organizations of different sizes in Figure 7, there is no significant difference among them in the number of months of operating expenses available. About half of large organizations (with revenues of \$5 million or more) responded that they had less than 3 months of operating expenses available, while 45 percent of small organizations (with revenues of less than \$1 million) said the same. Nearly 30 percent of small organizations had four to six months' worth of operating expenses available in cash. By contrast, only 23 percent of large organizations had four to six months' worth. Approximately 26 percent of small organizations and 27 percent of large organizations had more than seven months' worth.

**Figure 7: Percentage of Respondents Reporting Number of Months of Operating Expenses Available, by Organizational Revenue (%)**



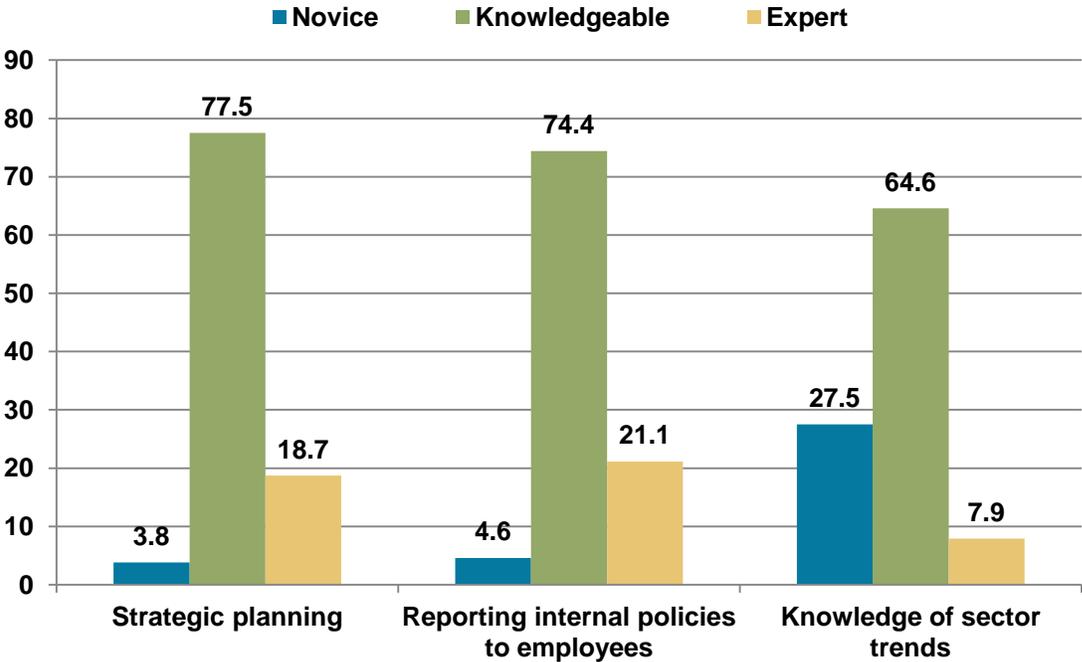
Note: \*May not be statistically meaningful because the sample contains fewer than 50 respondents.

## Level of Knowledge in Multiple Functional Areas

Respondents were also asked to rate themselves regarding their expertise in three distinct functional domains.

The first functional domain includes strategic planning, reporting internal policies to employees, and knowledge of sector trends (see Figure 8). Over a quarter of respondents (27.5 percent) rated themselves as novice in the area of knowledge of sector trends. Reporting internal policies to employees had the highest percentage (21.1 percent) who viewed themselves as expert followed by strategic planning (18.7 percent).

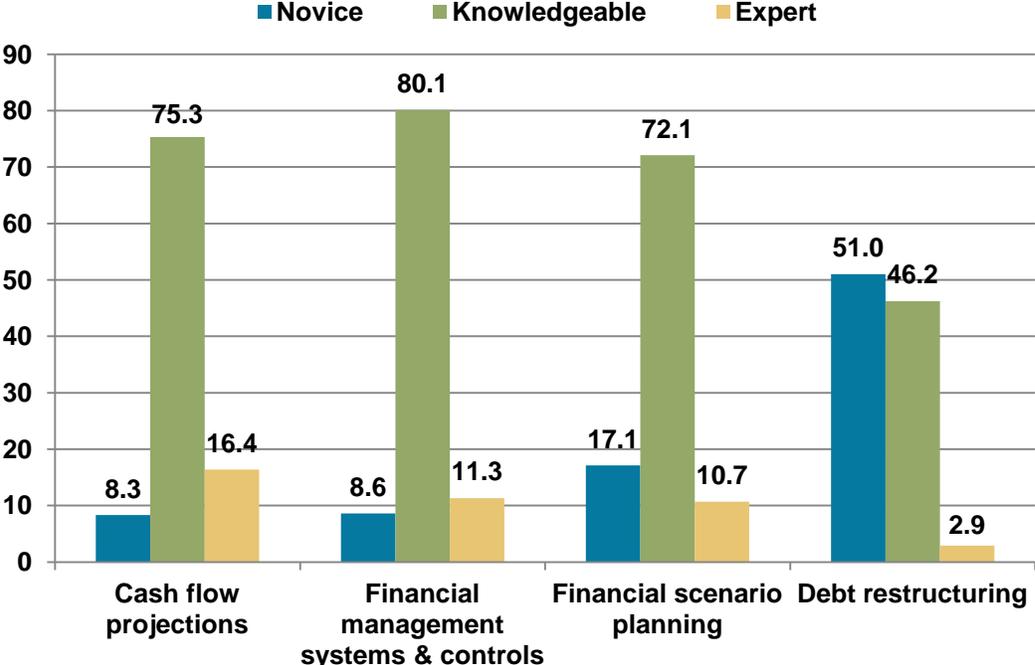
**Figure 8: Respondents Reporting Level of Knowledge with Various Functions (%)**



About 19 percent of Chief Executive Officers rated themselves as experts in reporting internal policies to employees (77.7 percent rated as knowledgeable). In contrast, 29.8 percent of Chief Financial Officers/Controllers/Financial Managers rated themselves as experts in the area of reporting internal policies to employees (67.3 percent rated themselves as knowledgeable).

The second functional domain includes cash flow projections, financial management systems and controls, financial scenario planning, and debt restructuring (see Figure 9). The vast majority of respondents rated themselves as knowledgeable with regard to financial management systems & controls (80.1 percent) and cash flow projections (75.3 percent). A high percentage of respondents reported themselves knowledgeable in financial scenario planning (72.1 percent). However, with regard to debt restructuring, over half (51 percent) rated themselves as novice and only 2.9 percent rated themselves as expert, the lowest among all four areas.

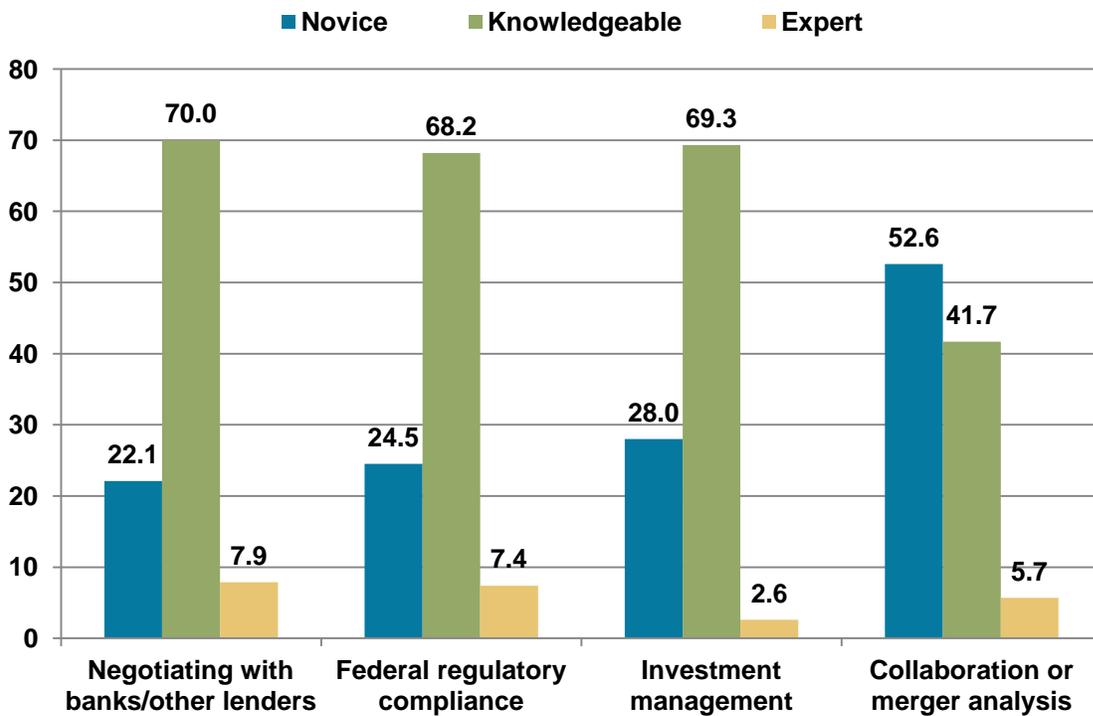
**Figure 9: Respondents Reporting Level of Knowledge with Various Functions (%)**



About 6.7 percent of Chief Executive Officers rated themselves as experts in financial scenario planning (76.4 percent rated as knowledgeable). In contrast, 22.8 percent of Chief Financial Officers/Controllers/Financial Managers rated themselves as experts in the area of reporting financial scenario planning (61 percent rated themselves as knowledgeable).

The third and final functional domain includes negotiation with banks and other lenders, federal regulatory compliance, investment management, and collaboration or merger analysis (see Figure 10). Collaboration or merger analysis had the highest percentage of respondents (52.6 percent) who rated themselves as novice. Investment management had the next largest percentage of respondents (28 percent) who rated themselves as novice followed by federal regulatory compliance (24.5 percent).

**Figure 10: Respondents Reporting Level of Knowledge with Various Functions (%)**

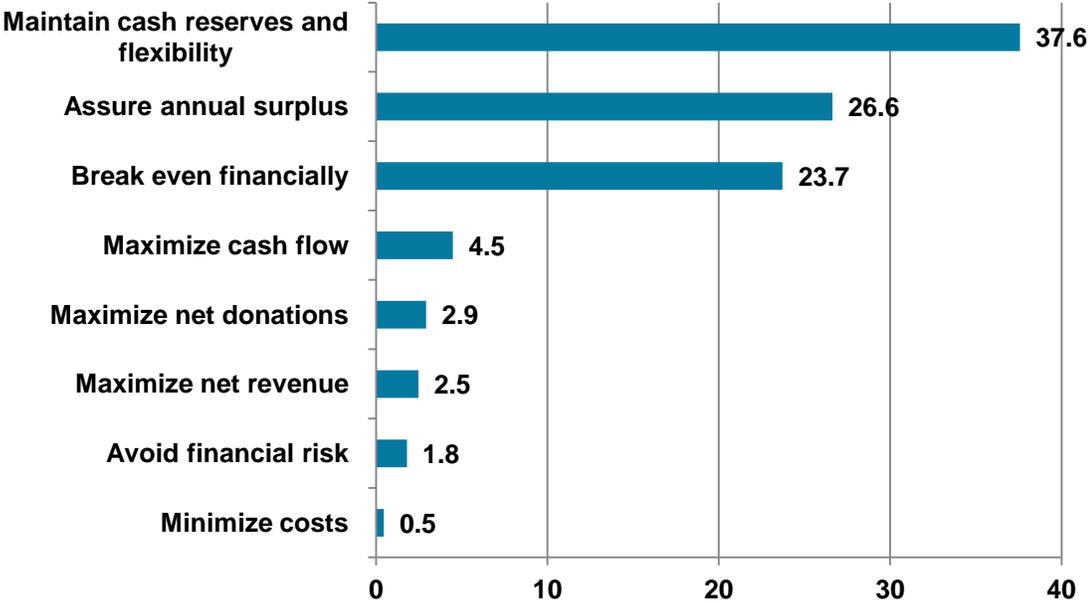


# II. Indicators for Programmatic and Financial Decision-making

## Primary Financial Objective of Organization

Maintaining a targeted level of cash reserves and financial flexibility (37.6 percent) and assuring an annual surplus so the mission can be achieved in down years (26.6 percent) were considered to be the foremost financial objectives for the organizations surveyed. Breaking even financially (23.7 percent) was also an important financial objective for the organization. Figure 11 shows that few organizations reported maximizing cash flow (4.5 percent), maximizing net donations (2.9 percent), and maximizing net revenue (2.5 percent) as primary financial objectives. Less than 2 percent of organizations considered avoiding financial risk as a primary financial objective for the organization.

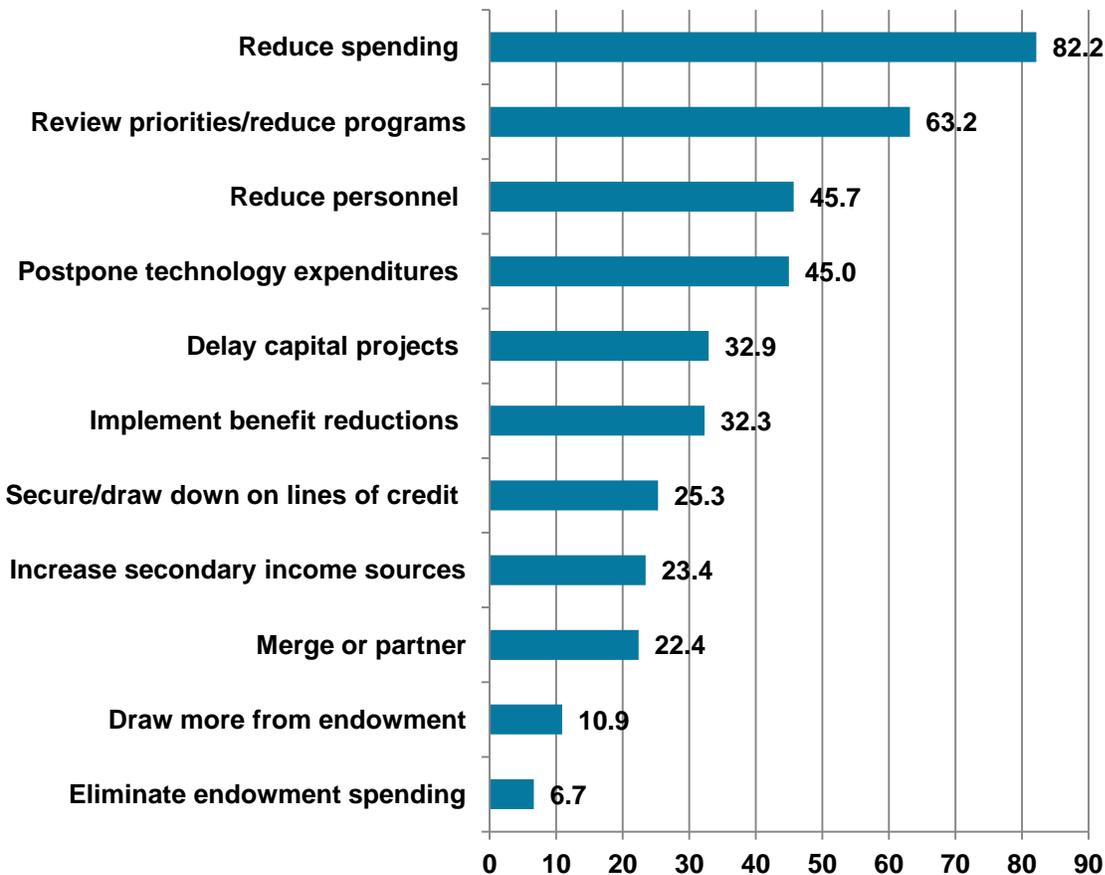
**Figure 11: Percentage of Organizations by Primary Financial Objective of Organization (%)**



## Tactics for Responding to Economic Crisis

In Figure 12, the majority of organizations (82.2 percent) reported that reducing spending was an effective tactic in responding to the recent economic downturn. Reviewing organizational priorities and making programmatic reductions (63.2 percent), reducing personnel (45.7 percent), and postponing IT expenditures (45 percent) were also effective tactics in responding to the economic climate. For about one-fifth of organizations, increasing secondary sources of income (e.g., renting out space, selling assets) and merging or partnering with other community organizations were reported as effective tactics (23.4 percent and 22.4 percent, respectively). Only 10.9 percent of organizations drew more from their endowment, and 6.7 percent eliminated endowment spending.

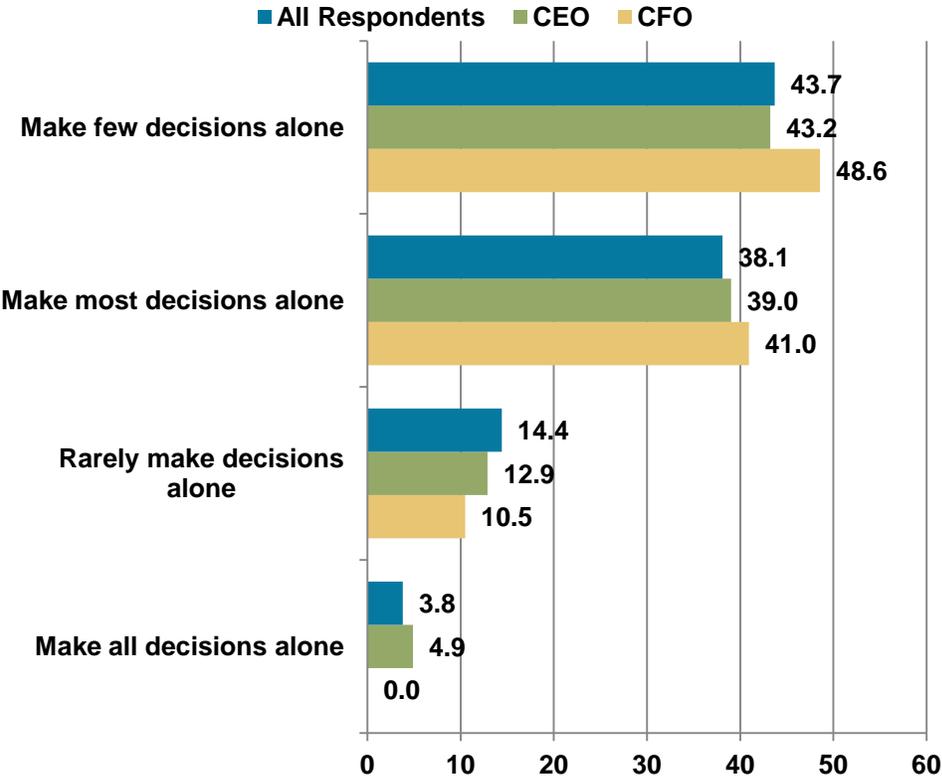
**Figure 12: Percentage of Respondents Who Rated Tactics as Effective when Responding to Economic Downturn (%)**



# Decisions about Financial Management

Respondents were asked the level of authority they possessed in regard to making financial management decisions (see Figure 13). About two-fifths of respondents, 43.7 percent, made few decisions alone, whereas 38.1 percent made most of the decisions alone. The remaining respondents rarely made decisions alone (14.4 percent) and 3.8 percent made all decisions alone. When looking at the particular officer who makes financial decisions at organizations, 43 percent of Chief Executive Officers (CEOs) surveyed reported that they made few decisions alone, and nearly 49 percent of Chief Financial Officers (CFOs) said the same. Approximately another 40 percent of CEOs and CFOs responded that they made most decisions alone (39 percent and 41 percent, respectively).

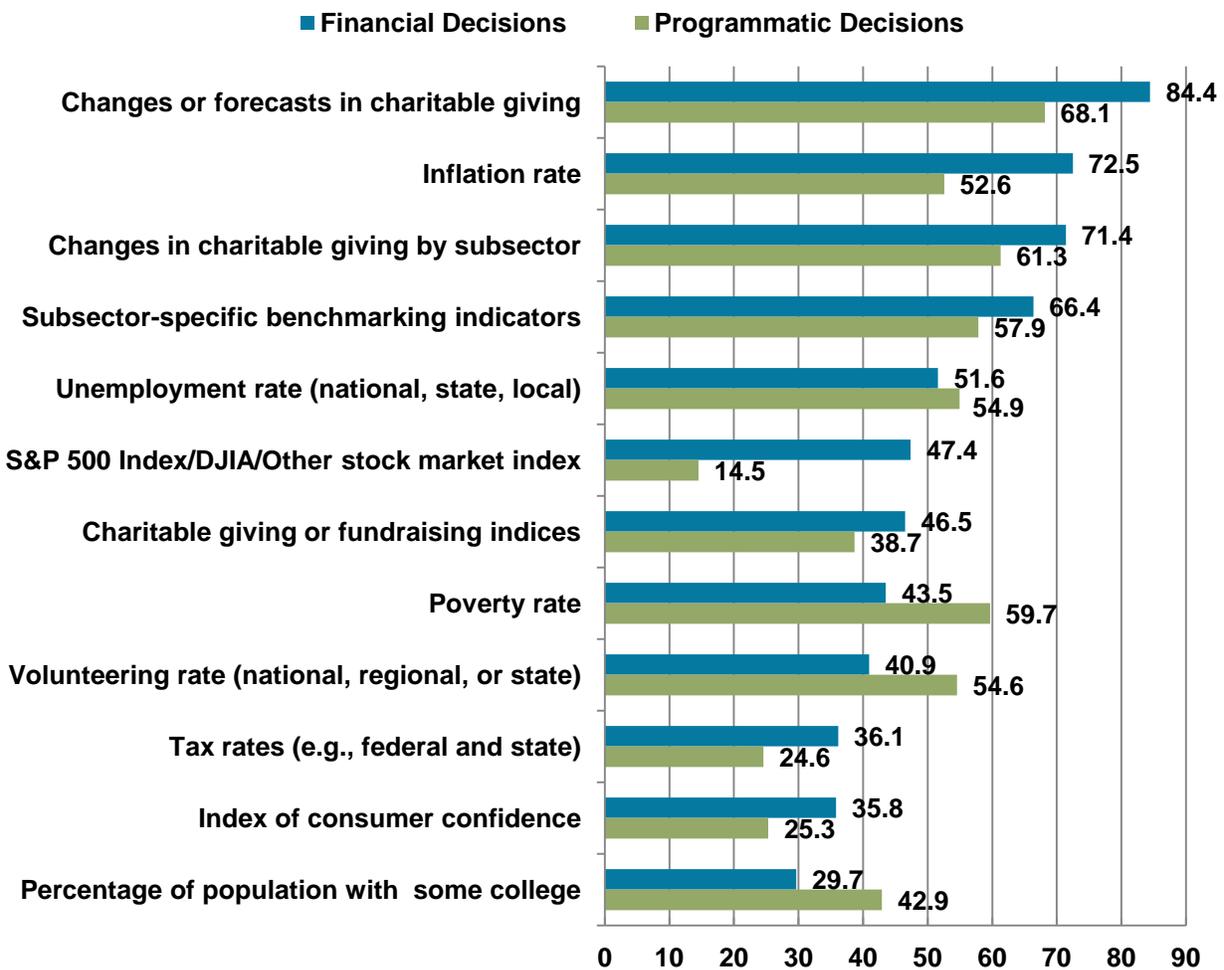
**Figure 13: Who makes the financial management decisions (%)**



## Use of Indicators for Financial and Programmatic Decision-making

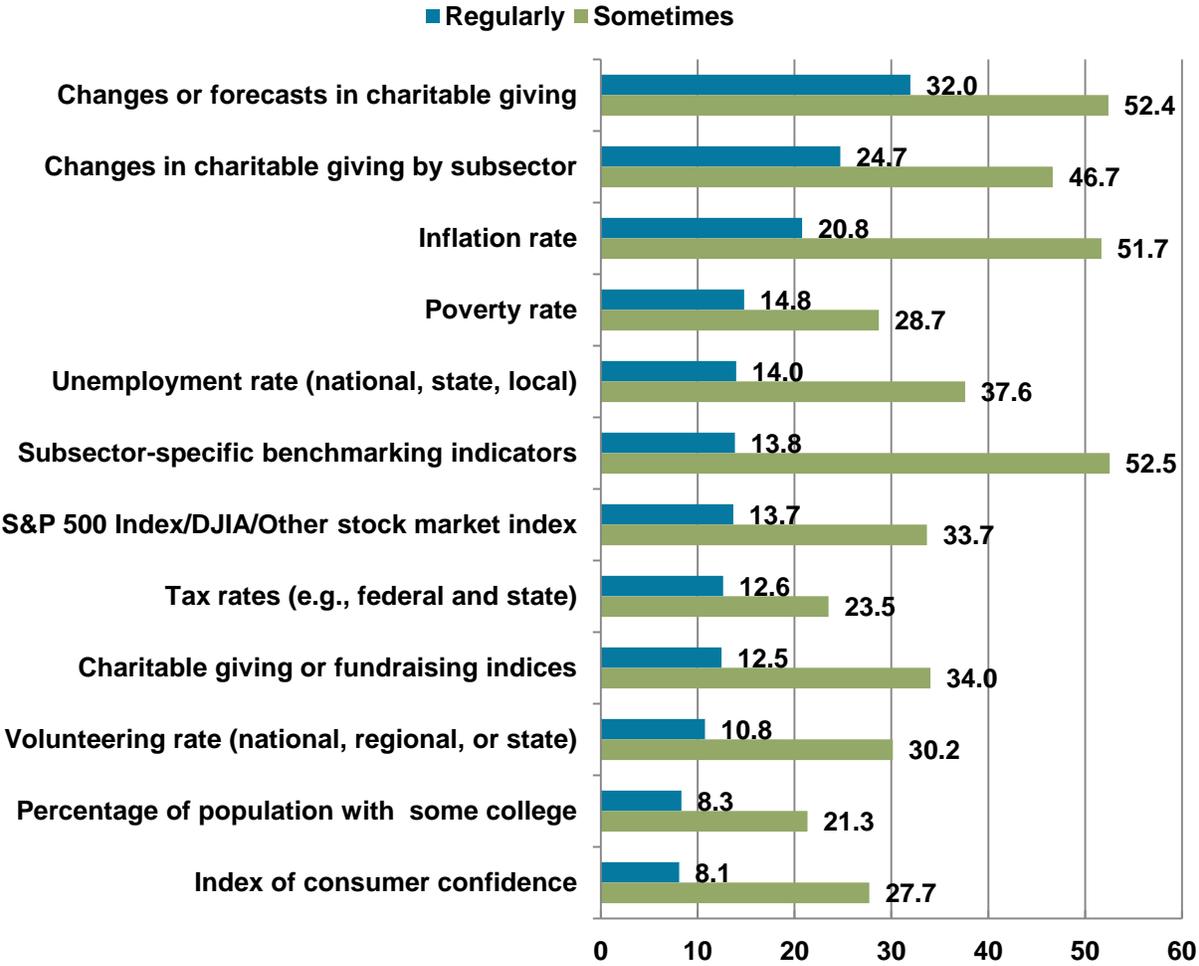
As shown in Figure 14, the majority of nonprofit organizations use changes or forecasts in charitable giving, either regularly or sometimes, for both financial and programmatic decisions (84.4 percent and 68.1 percent, respectively). Nonprofit managers also use inflation rate (72.5 percent), changes in charitable giving by subsector (71.4 percent), and subsector-specific benchmarking indicators, such as cost per graduate (66.4 percent) for financial decision-making. Respondents reported using stock indices such as S&P 500 and DJIA more for financial decision-making (47.4 percent) than programmatic decision-making (14.5 percent). However, respondents use poverty rates more for programmatic decision-making (43.5 percent) than financial (59.7 percent).

**Figure 14: Use of Indicators for Programmatic and Financial Decision-making (%)**



Nonprofit organizations regularly use changes or forecasts in charitable giving (32 percent) and changes or forecasts in charitable giving by subsector (24.7 percent) when making financial decisions. About 20 percent of organizations regularly use inflation rates (20.8 percent) and poverty rates (14.8 percent) when making financial decisions. Only 13.7 percent of organizations regularly use S&P 500 Index or other stock indices (see Figure 15).

**Figure 15: Use of Indicators for Financial Decision-making (%)**



## What are important macroeconomic finance indicators for nonprofits?

Besides education and experience, the ability of nonprofit managers to make accurate financial and economic decisions depends on the information and tools that nonprofit organizations can access. Three factors identified in the literature as particularly significant to nonprofit organizations in general (regardless of the particular area of service) are unemployment rate, changes in federal and state budgets, and state economy.

- **Unemployment rate**

The importance of unemployment rate rises from the observation that there is a strong correlation between increases in unemployment rates and decreases in individual giving. In general, when unemployment rate goes down, charitable giving rises; and when unemployment rate goes up, giving drops. Of course, there are exceptions, but it seems that there are far fewer exceptions than with other macroeconomic indicators. If nonprofits want to focus on a single economic measure as an early warning indicator for revenue prediction, unemployment rate may offer a better guidance.

- **Changes in federal and state budgets**

Changes in federal and state budget can have a direct influence on a nonprofit organization, if it heavily relies on government funding. This factor can also indirectly affect a nonprofit, because government funding may affect the overall supply and demand equilibrium in the organization's area of operation.

- **State economy**

The usefulness of nation-wide indicators may be limited for some nonprofits, because their services are often bounded by geography and most charitable giving flows to local causes. Therefore, as suggested in literature, the health and directions of a state economy may be a better predictor than national economic indicators for nonprofits.

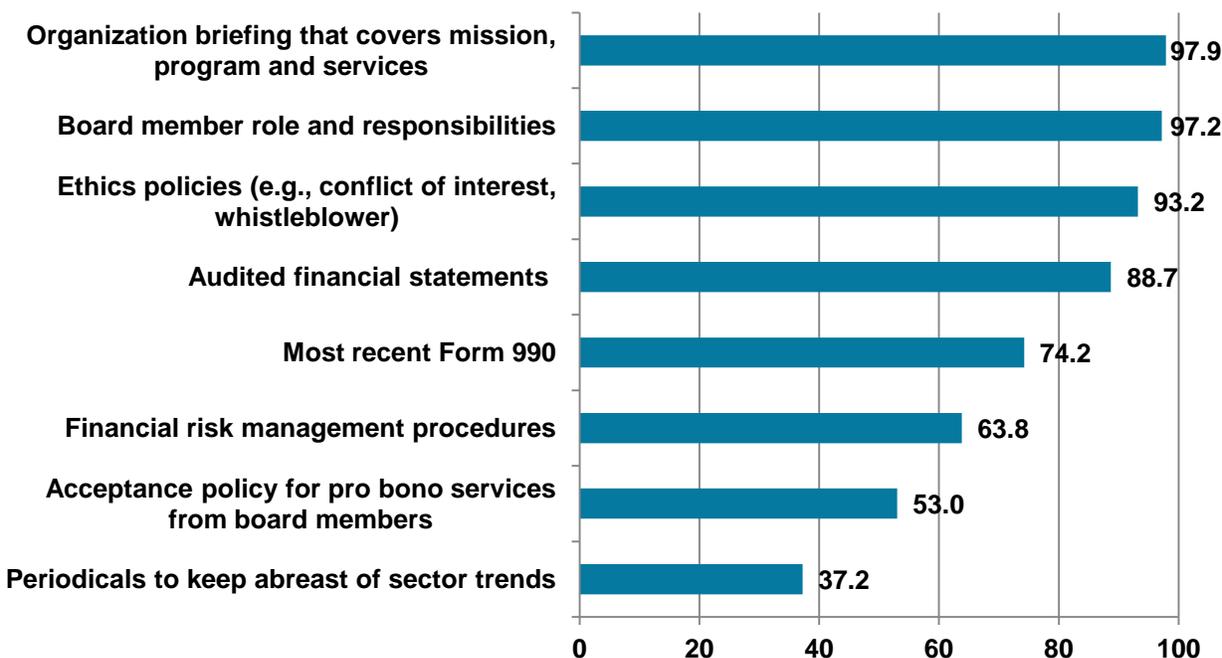
Source: Raymond, 2010.

# III. Board Role & Governance

## New Board Member Orientation

The majority of board members received a detailed briefing of the organization (97.9 percent) and information on board member role and responsibilities (97.2 percent) as part of their orientation (see Figure 16). More than 93 percent of organizations also provided board members with ethics policies (such as conflict of interest, and whistleblower) and about 89 percent provided audited financial statements. Only 74 percent of organizations provided their board with the most recent Form 990 and about 64 percent provided information on financial risk management procedures. Organizations were less likely to provide periodicals or information to inform board members of sector trends (37.2 percent).

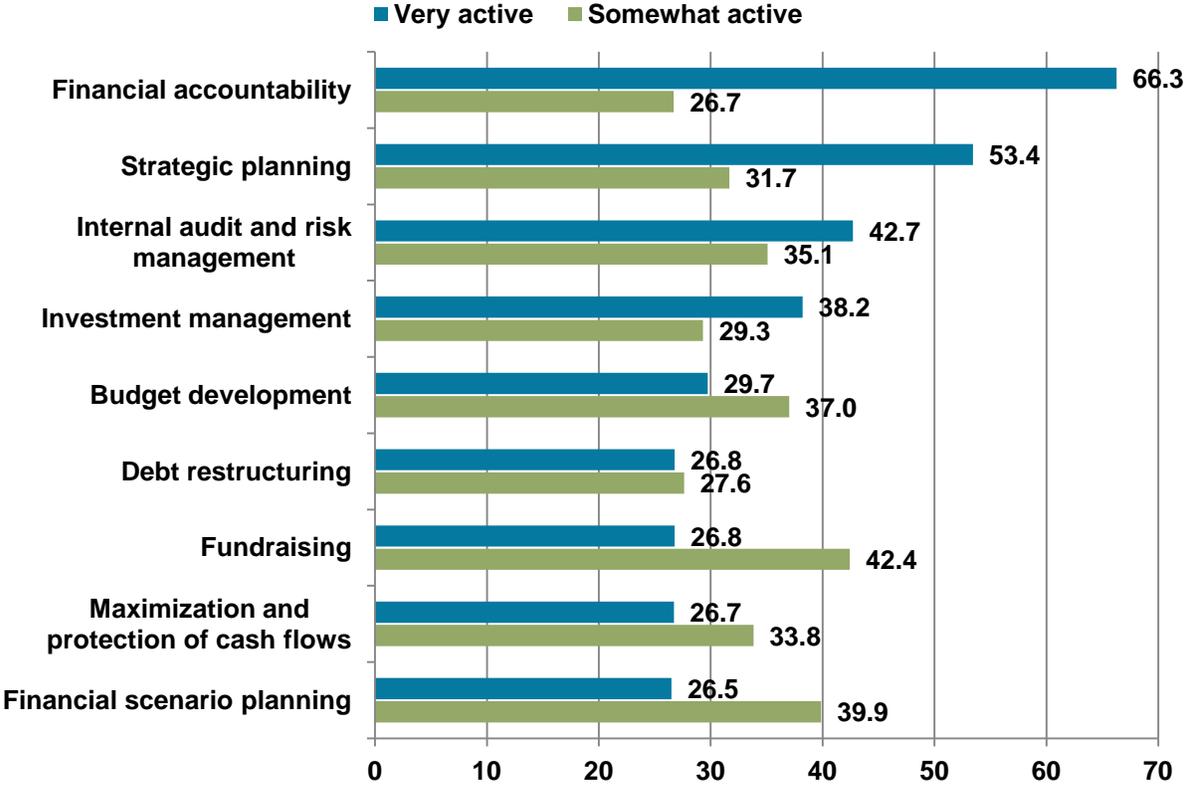
**Figure 16: Percentage of Organizations Providing Board Orientation Materials, by Type of Materials (%)**



# Board Involvement

In Figure 17, organizations were asked how active their board was in carrying out financial functions. The majority of organizations reported that boards were very actively involved in financial accountability (66.3 percent). Other major functions that boards were very active in include strategic planning (53.4 percent) and internal audit and risk management (42.7 percent). By contrast, relatively fewer organizations said that their boards were active in fundraising (only 26.8 percent reporting very active, and another 42.4 percent reporting somewhat active). In addition, nearly two-fifths of organizations reported that their boards were very active in investment management (38.2 percent) and budget development (29.7 percent). About 66 percent of organizations reported that their boards were very or somewhat active in financial scenario planning – used by organizations to test out theories and model responses to possible future events. In addition, 60.5 percent of respondents were very or somewhat active in maximization and protection of cash flows.

**Figure 17: Percentage of Organizations Reporting Board Involvement in Financial Management, by Financial Functions (%)**



# Do board function and performance affect organizational effectiveness?

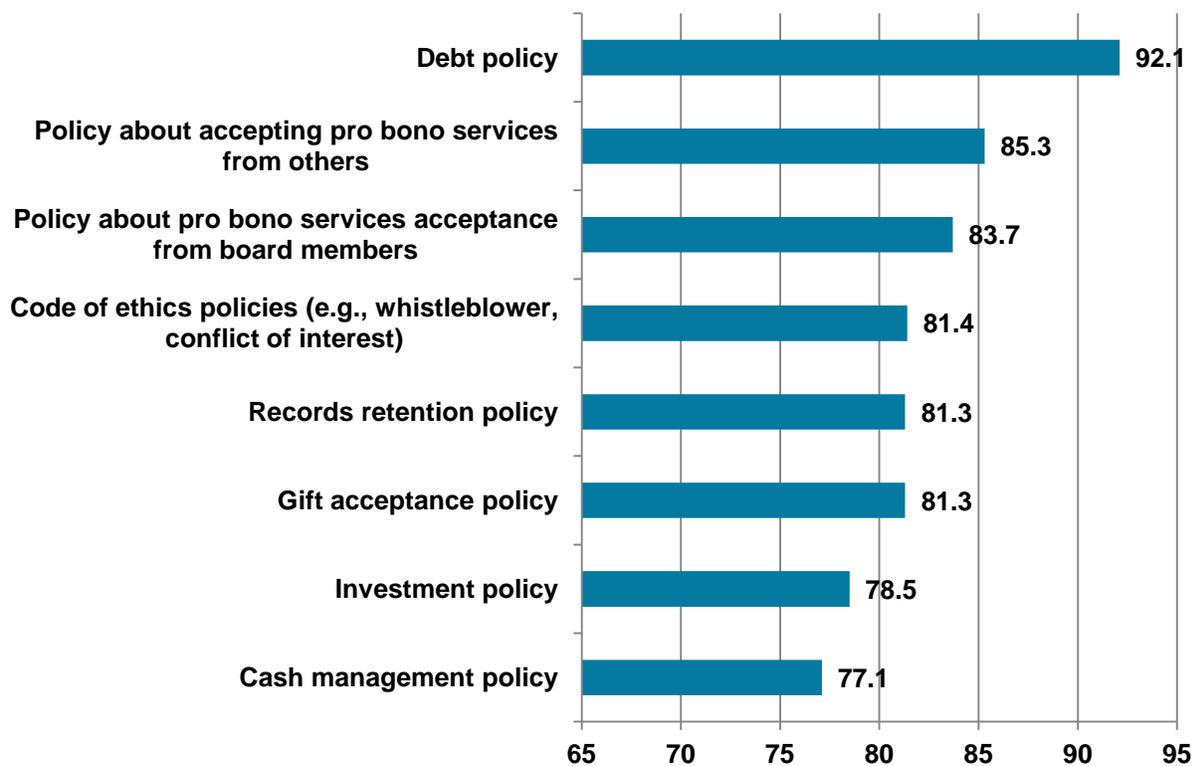
Nonprofit boards serve as a mechanism to reduce environmental uncertainty and perform important boundary-spanning functions. Research finds significant relationships between board and organizational effectiveness. In particular, a study suggests that boards of effective organizations are more involved in strategic planning, policy formation, financial planning and control, resource development, program review, and dispute resolution.

Sources: Green & Griesinger, 1996; Middleton, 1987; Miller-Millesen, 2003; Ostrower & Stone, 2006.

## Board Review

Among the items that board members reviewed during the period between 2007 and 2010 (see Figure 18), debt policy was the most reviewed (92.1 percent) followed by policy regarding pro bono services from others (85.3 percent) and from board members (83.7 percent). Policies regarding records retention and gift acceptance were both equally reviewed by organizations (at 81.3 percent each), while policies on investment and cash management were reviewed by under 80 percent (78.5 and 77.1 percent, respectively) of those surveyed.

**Figure 18: Percentage of Organizations with Board Review, by Type of Documents and Policies (%)**

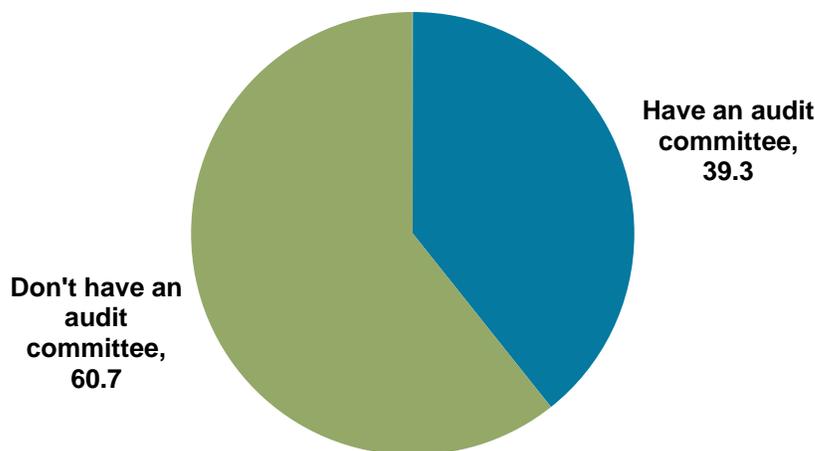


\*Note that about 500 respondents answered this question.

## Audit Committee

In an effort to provide more transparency and accountability in the nonprofit sector, the Internal Revenue Service implemented a new Form 990 in 2009 that represents good governance practices. One recommendation is to create a process for reviewing the Form 990 before it is filed with the Internal Revenue Service, for example reviewing by a finance or audit committee of the organization. In this study, it was found that only 39.3 percent of organizations had an audit committee. The majority, 60.7 percent, did not have an audit committee (see Figure 19).

**Figure 19: Percentage of Organizations That Have or Do Not Have an Audit Committee (%)**



## Why should a nonprofit organization consider establishing an audit committee?

Developing an audit committee is often recommended for nonprofit organizations as a proactive way to improve financial oversight. An audit committee serves an important role in helping the board fulfill its fiduciary obligations. Its key responsibilities may include:

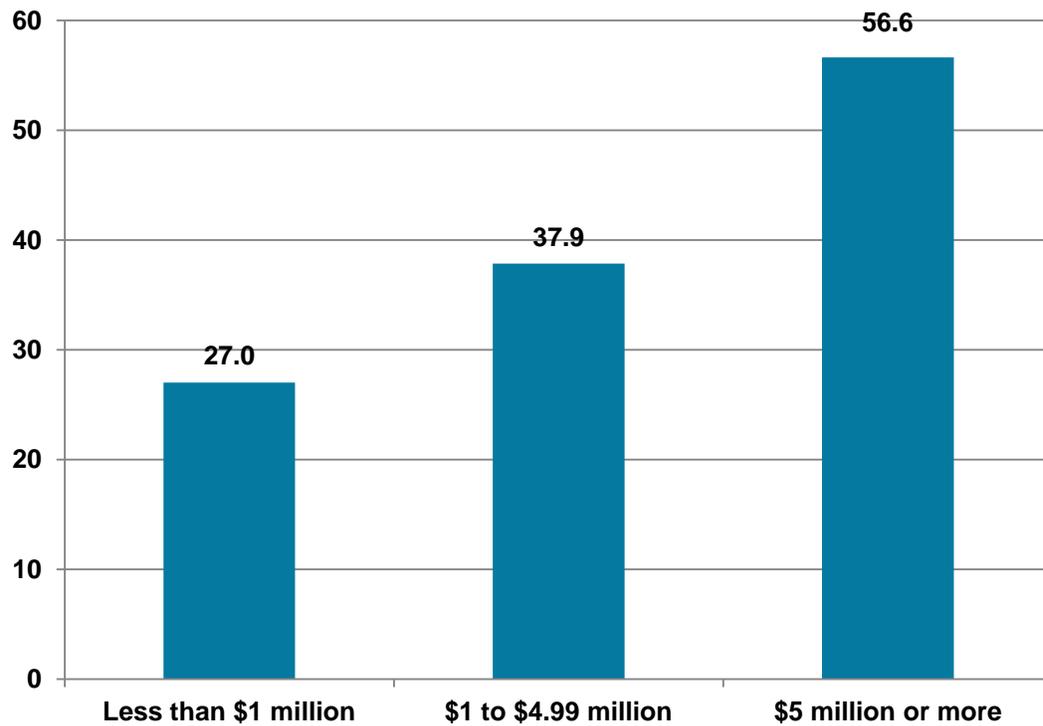
- Overseeing accounting policies and internal control processes;
- Assessing potential business risks and assisting the organization with adequate planning to address these risks;
- Monitoring the roles of the board, management, and auditors; and
- Establishing policies to prevent fraud.

Involving at least one finance professional on the audit committee is also strongly recommended to help the committee better perform its duties.

### *Audit Committee by Organizational Revenue*

When examining the percentage of organizations that have an audit committee based on organizational revenue (see Figure 20), 27 percent of organizations with revenues of less than \$1 million reported having an audit committee. This was the smallest percentage among the three different size categories. Of organizations with revenues of \$5 million or more, around 57 percent reported having an audit committee, which was the largest among the three categories.

**Figure 20: Percentage of Organizations That Have an Audit Committee, by Organizational Revenue (%)**



# IV. Financial Management: Controls & Procedures

## Financial Manuals and Board-approved Spending Policies

Many organizations experience uncertain events and need to make provisions to buffer themselves against financial emergencies or shocks. Being able to weather shocks not only contributes to financial stability at the organization level but also increases the stability of the economy as a whole.

In Table III below, about 80 percent of organizations reported having a fiscal policies and procedures manual, which outlines financial and accounting policies and procedures for staff, and documents internal controls for the organization. More than three-quarters (77.4 percent) of organizations had a board-approved spending policy regarding operating expenses to be paid from endowment principal or earnings. In addition, two-thirds (66.2 percent) of organizations had a board-approved spending policy regarding capital expenses to be paid from endowment principal or earnings.

**Table III: Percentage of Organizations Having Financial Manuals and Board-approved Spending Policies (%)**

Does your organization have a:	Yes	No	Don't Know
Fiscal policies and procedures manual	80.3	18.4	1.4
Board-approved spending policy regarding <b>operating expenses</b> to be paid from endowment principal or earnings	77.4	21.3	1.3
Board-approved spending policy regarding <b>capital expenses</b> to be paid from endowment principal or earnings	66.2	31.3	2.6

## **Annual Operating Budget, Multi-year Strategic and Financial Plan, and Capital Projects Budget**

Respondents were asked to indicate how frequently these three items were prepared and reviewed by their board. The regularity of preparing and reviewing ranged from monthly, to quarterly, annually, or prepared but not reviewed, and not prepared.

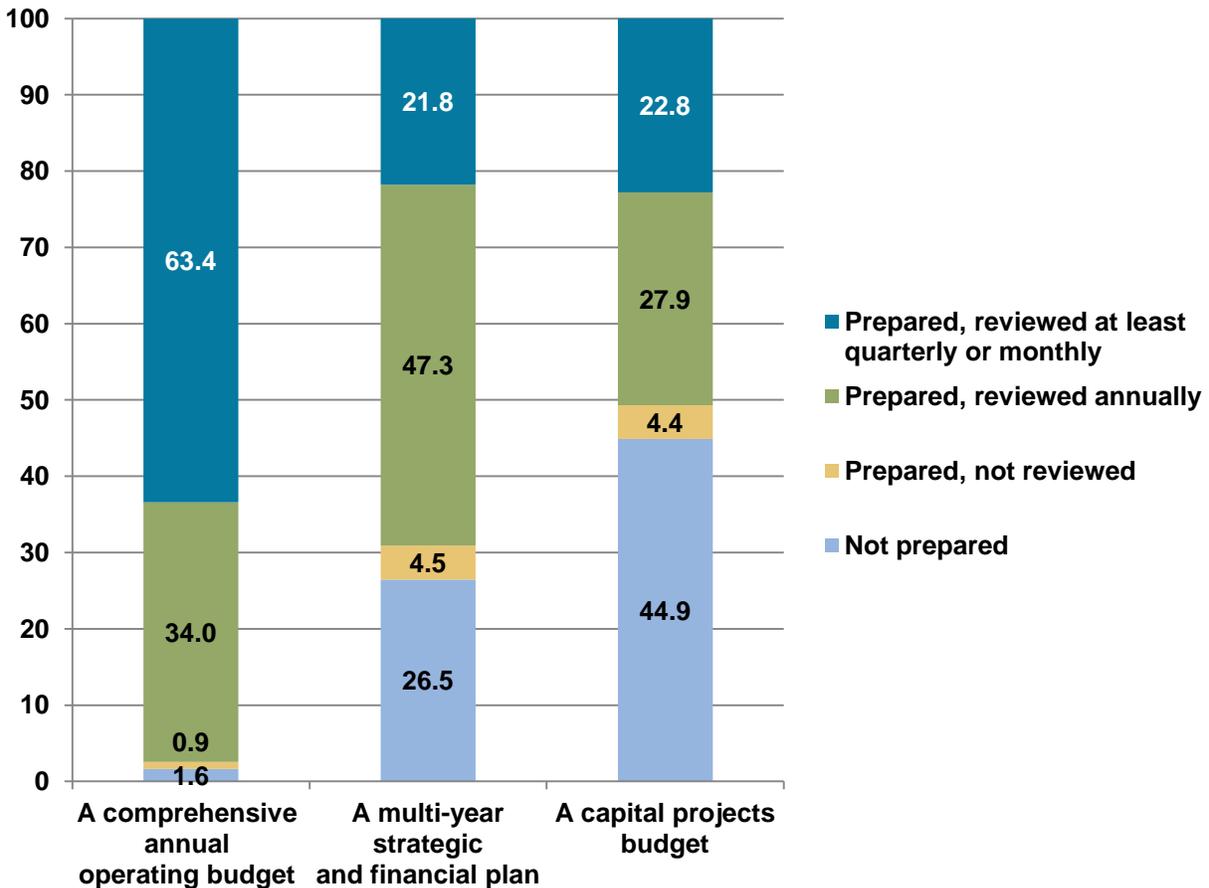
- An **annual operating budget** is a fiscal reflection of the principles of an organization and a very concrete measure of the organization's priorities. It is also a plan that shows how much money an organization anticipates receiving over the course of the year and how it plans to spend the money. Once approved by an organization's board, the budget serves as the board's official authorization of the expenditure of the organization's funds. Thus a budget may also serve an authorization and control function.
- A **multi-year strategic and financial plan** ensures that the organization maintains services and programs at recommended levels, manages cash flows and maintains operational flexibility, protects and maintains infrastructure, assures efficient use of resources, and manages risk related to debt and liabilities.
- A properly prepared and adopted **capital projects budget** is essential for proper planning, funding and implementation of major projects. Capital projects are different from programs adopted in the operating budget, often representing very large financial obligations that may span two or more fiscal years. Therefore, it is important that they be properly planned, budgeted, and tracked.

Figure 21 shows that more than 97 percent of organizations have prepared a comprehensive annual operating budget, which the board reviews annually (34 percent) and quarterly or monthly (63.4 percent). Less than 3 percent of organizations have not prepared an annual operating budget or have prepared one, but it is not reviewed by the board.

More than one-quarter of organizations (26.5 percent) have not prepared a multi-year strategic and financial plan. About 69 percent of organizations have prepared a multi-year strategic and financial plan, which is reviewed by the board annually (47.3 percent) and quarterly or monthly (21.8 percent).

Nearly 45 percent of organizations have not prepared a capital projects budget. Approximately 50 percent of organizations have prepared a capital projects budget that is reviewed by the board annually (27.9 percent) and quarterly or monthly (22.8 percent).

**Figure 21: Percentage of Organizations That Prepared and Reviewed Annual Operating Budget, Multi-year Strategic and Financial Plan, and Capital Projects Budget (%)**



## Target Level of Revenue and Support, Budget Analysis, and Cash Forecast

The survey also asked questions about how frequently the tools for financial management were prepared and reviewed by the organization's board.

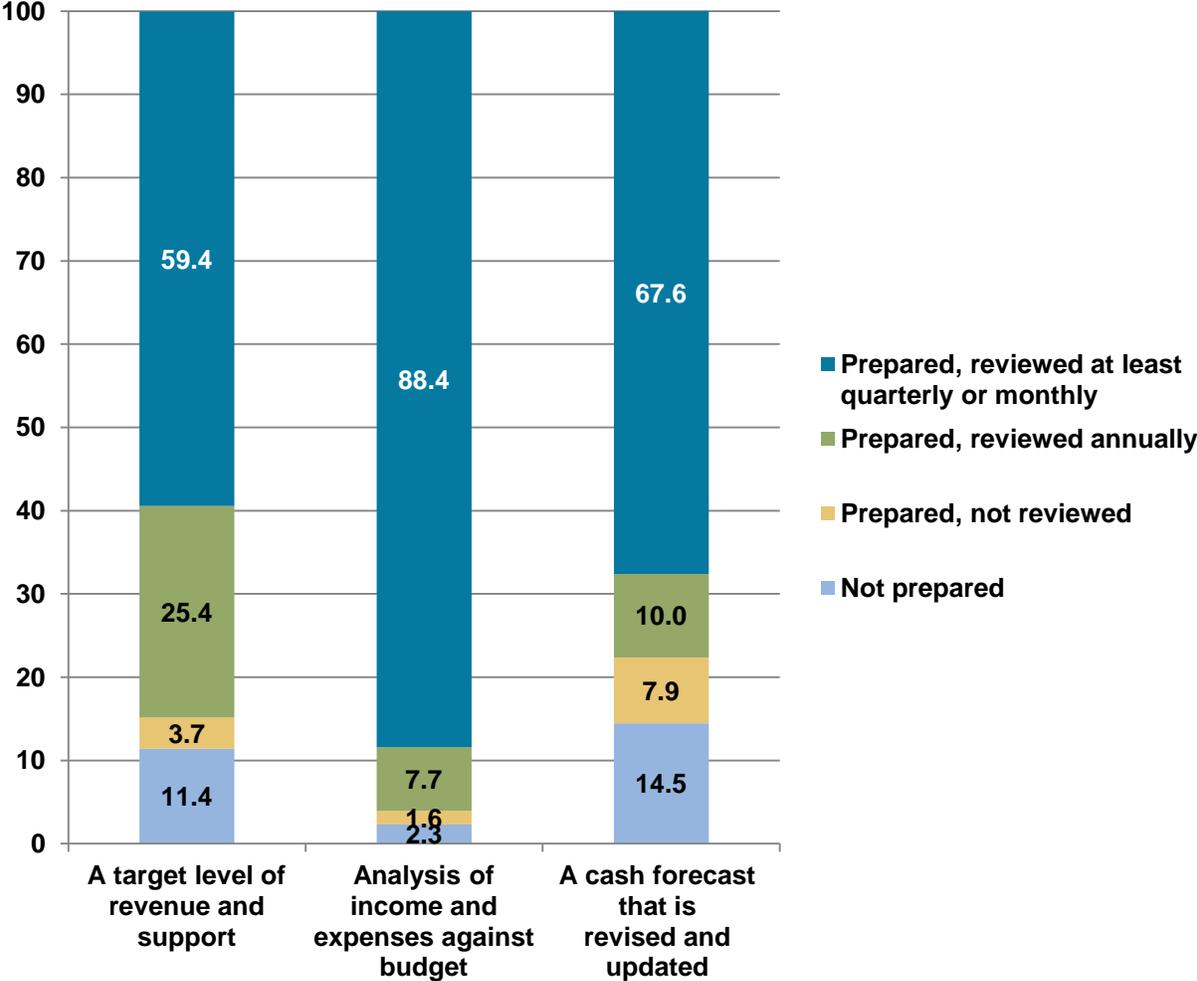
- A **target level of revenue** is a specific amount or range of revenue that an organization strives to reach and to maintain. By reaching this target level, organizations can secure the revenues necessary to implement their strategic and financial plans, maintain a healthy operating and capital projects budget, and most importantly, have enough funds to carry out programs and initiatives that are central to their nonprofit mission and core values.
- By maintaining a thorough **analysis of income and expenses against budget**, organizations can track how well their overall financial situation and strategy is faring compared to their original budget. Organizations are able to gauge their financial health and the feasibility of operation and certain projects and programs.
- With a **cash forecast that is revised and updated**, organizations can continuously estimate the inflow and outflow of cash projections over a period of time. Organizations can use this to determine if they will have enough cash on hand for basic operations, programs, capital projects, etc.

In Figure 22, nearly 85 percent of organizations prepared a target level of revenue and support, of which 59.4 percent was reviewed quarterly or monthly and 25.4 percent was reviewed annually. About 4 percent of organizations prepared but did not review this document while 11.4 percent of organizations did not prepare at all.

Almost all organizations (96.1 percent) prepared an analysis of income and expenses against budget. The majority of organizations (88.4 percent) prepared and reviewed this quarterly or monthly while nearly one third (7.7 percent) prepared and reviewed this at least annually. Only a very small percentage of organizations (3.9 percent) prepared this but did not review or just did not prepare at all.

Finally, over three quarters (77.6 percent) of organizations prepared and reviewed a cash forecast that is revised and updated, which was reviewed by the board annually (10 percent) and quarterly or more often (67.6 percent). Nearly 15 percent of respondents did not prepare a cash forecast.

**Figure 22: Percentage of Organizations That Prepared and Reviewed Target Level of Revenue and Support, Budget Analysis, and Cash Forecast (%)**



# V. Closing thoughts

*Financial Literacy and Knowledge in the Nonprofit Sector* is among one of the first studies to explore this topic and explore how such knowledge informs practices. This is not only important for the individuals who are most responsible for financial decision-making at the organization, but also for the nonprofit sector as a whole, particularly in tough economic times. As the nonprofit sector works to regain economic well-being, the role of financial managers becomes even more pronounced.

We are not surprised to discover that this snapshot of the nonprofit sector shows differences in financial literacy and knowledge.<sup>1</sup> This disconnect between nonprofit financial managers' perceptions about their own financial knowledge and actual financial literacy has potentially significant implications for managers and board members, as well as for members of the public who contribute to these organizations and place their trust in them.

This study found that many organizations strive to meet an appropriate liquidity target over time – that is, maintaining a targeted level of cash reserves and financial flexibility and assuring an annual surplus so the mission can be achieved in down years. As organizations deal with fluctuations in their sources of funding, having an understanding of the need for financial flexibility has taken on increased significance, and financially literate managers can help their organizations craft sound strategies and objectives that will keep their organizations not only afloat, but thriving, even during temporary economic declines.

Nonprofit financial management has come under increased scrutiny in the past several years, and monitoring mechanisms, such as audit committees, have gained a more prominent role. However, this study illustrates the lack of an audit committee at a majority of organizations surveyed. Their mandate is to help the board of directors maintain the organization's overall integrity, financial credibility and long-term viability, leading to a more robust sector and, ideally, an increase in public trust. Today, with the increased focus on good governance and fiscal responsibility, audit committee members of nonprofit organizations are under greater scrutiny than ever as they carry out their mission of stewardship. This report underscores the need for many nonprofit organizations to assess their financial monitoring mechanisms in light of the environment of analysis and accountability.

An important component of financial management of nonprofit organizations is the ability to forecast based on external factors. While this study found that managers are aware of the importance of financial scenario planning, most board members are not actively involved in this type of planning, which demonstrates areas for growth or education. Scenario planning increases an organization's capability to more skillfully observe its environment, leading to more robust long-term organizational learning. Most strategic planning tools are backward looking or are focused on internal problems; scenarios are forward looking and external. This puts in place a powerful opportunity for organizational learning and for developing foresight.

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<sup>1</sup> This study is not nationally representative, but is instead suggestive of the response of medium-size nonprofit organizations, that is with organizational revenue between \$1 and \$5 million.

Robust, timely, and accurate information are an essential component of any effort to persuade individuals or nonprofits to make *different* decisions from the ones they might make in the absence of particular pieces of information. And it is an integral part of any attempt to hold those who make decisions accountable for the consequences of the decisions they make. In addition, rising expectations – including the growing expectation that those entrusted with scarce resources (such as charitable gifts) have to demonstrate that they have used them wisely, for the purposes for which they were provided – have also contributed to an increasing demand for and use of data. The majority of nonprofit organizations use changes or forecasts in charitable giving, either regularly or sometimes, for financial decisions, and nonprofit managers also use inflation rate, changes in charitable giving by subsector, and subsector-specific benchmarking indicators for financial decision-making. While nonprofits have made progress in recent years, there is still much room for improvement, and the proper use of financial and other indicators can help organizations make sound financial decisions that benefit both their programs and their bottom line.

We hope that this report serves as a starting point for organizations and nonprofit financial managers who seek best practices in financial management and who strive to implement sound financial policies that enhance organizations' ability to provide programs and services while maintaining the financial health of the sector. Nonprofit boards and financial managers have a responsibility to their organizations and stakeholders, and this report highlights the need for financial literacy among these individuals as the nonprofit sector expands its size and scope.

# VI. Methodology

## Overview

The purpose of this study is to examine nonprofit organizations' financial literacy and knowledge and explore how such knowledge informs their practices. In particular, we focused on those in leadership positions within nonprofit organizations who were most responsible for financial decision-making at the organization. This study consisted of a Web survey distributed to 5,000 medium-sized arts, health, human services, education, civic, and environmental nonprofit organizations across the United States<sup>2</sup>. The Indiana University Center for Survey Research (CSR) implemented the survey. Dr. Una Osili, Director of Research at the Center on Philanthropy at Indiana University, oversaw analysis procedures.

## The Questionnaire

An introductory letter was mailed by the CSR between October and November 2010, followed by three reminder emails with a survey link to the Web survey. Those who had not responded to the survey were then mailed a postcard. The Web survey consisted of six main sections with 31 questions. These questions ranged from how their organizations fared during the recent economic downturn to financial literacy, board involvement, and the organizational and financial decision-making process. Further, respondents were asked demographic questions such as education, length of employment, and role in decision-making.

## Final Disposition Summary

When data collection ended, 526 respondents had completed the survey. The response rate was 15.3 percent. After cleaning the dataset, the final number of responses used to calculate the information presented in the report was 514. However, the sample size for each question changes based on the number of organizations that responded to that particular question.

Disposition	Count
Complete	411
Partial complete	115
Total	526
Total used in analysis	514
Undeliverable	1,556
No response	2,918
Response rate	15.3%
Total mailed out	5,000

## The Sample

The stratified random sample was drawn by the National Center for Charitable Statistics at the Urban Institute. The sample of 5,000 organizations took into account whether an organization had an annual revenue between \$100,000 and \$100 million. Specifically, higher education institutions, medical hospitals, and international organizations were not included in the sample, as well as support organizations and foundations.

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<sup>2</sup> This study is not nationally representative, but is instead suggestive of the response of medium-size nonprofit organizations, that is with organizational revenue between \$1 and \$5 million.

Large organizations were defined as those with between \$5 million and \$100 million in direct public support. Medium-sized organizations had charitable revenue between \$1 million and \$4.99 million. Small organizations had charitable revenue less than \$1 million in direct public support. For each subsector, the survey sample study was designed in a manner such that the sample is more representative of medium-sized nonprofit organizations, rather than being representative of the entire non-profit sector.

When the final sample is broken down by subsector, we find that the percent of organizations in the sample belonging to each subsector corresponds to the breakdown by subsector of all surveys mailed out. Human services organizations make up 58 percent of the sample, and make up about 61 percent of organizations that the survey was fielded to. At the lower end, organizations dedicated to arts and culture constitute 4.9 percent of the sample, and make up 4.2 percent of organizations the survey was mailed to.

Subsector	Number of Surveys mailed	Percent of Total Surveys mailed	Number of Respondents	Percent of Total Respondents
Arts	418	8.4%	54	10.5%
Education	458	9.2%	46	8.9%
Environment	208	4.2%	25	4.9%
Health	448	9.0%	43	8.4%
Human Services	3,046	60.9%	298	58.0%
Civic	422	8.4%	48	9.3%

The examples below serve to illustrate the composition of the final sample in this study:

- **Arts, Culture, and Humanities** – museums, performing arts theatres, humanities, and historical societies
- **Education** – elementary and secondary schools, vocational/technical schools, adult continuing education, libraries, or student service organizations
- **Environment** – natural resources conservation and protection, pollution abatement, or environmental education
- **Health** – clinics, hospices, mental health care centers
- **Human services** – food banks, shelters, YMCAs, youth and family services
- **Civic** – community development organizations, or civil rights groups

### Ordinary Least Squares Regression

Independent Variables	Dependent Variable: Log of Total Annual Revenue of Organization
Test scale†	0.155** (0.057)
Courses††	0.163** (0.052)
Male	0.360** (0.109)
Age of organization	0.008* (0.003)
Number working full-time managing organization's finance or accounting	0.745*** (0.067)
Have less than 3 months' operating expenses in cash form (d)	-0.832* (0.412)
Have 4 to 6 months' operating expenses in cash form (d)	-0.943* (0.418)
Have 7 to 12 months' operating expenses in cash form (d)	-0.856* (0.420)
Number of board members	0.134* (0.052)
Make few decisions alone (d)	0.096 (0.164)
Make most or all decisions alone (d)	-0.128 (0.165)
Have fiscal policies manual (d)	-0.029 (0.138)
Have operating expenses policy (d)	-0.112 (0.134)
Have audit committee (d)	0.293* (0.113)
N	403
Adjusted R-squared	0.4108

Note: Regression was also controlled for presence of a capital expenses policy through a dummy variable

Statistically significant at \* p<0.05 \*\* p<0.01 \*\*\* p<0.001

(d) indicates discrete changes in dummy variable from 0 to 1

† Test Scale: Responses to financial literacy questions. 0- At least one incorrect, rest of responses "don't know", 1- All three responses were "don't know", 2- One correct, 3- Two correct, 4- All correct

++ Courses: Number of classes taken in finance and economics. 1- Zero, 2- one or two, 3- three or four, 4- more than five

Reference group is female respondent, no written financial policies or audit committee, rarely makes decisions alone, organization has more than 12 months' operating expenses in cash form

Respondents who had more training in finance and performed better on the financial literacy questions asked in this survey tended to be from organizations with larger revenues rather than from smaller organizations. Large organizations by revenue also tend to have more full-time staff dedicated to finance and accounting, have more than 12 months' operating expenses in cash form, and have more board members and an audit committee.

### Ordinary Least Squares Regression

Independent Variables	Dependent Variables: Financial Literacy Measures	
	Test Scale <sup>^</sup>	Self-reported Knowledge <sup>^^</sup>
Advanced degree <sup>†</sup> (d)	0.186* (0.094)	-0.165 (0.045)
Male	0.162 (0.095)	0.105* (0.046)
Log of total revenue	0.133*** (0.037)	0.070*** (0.018)
Number of board members	-0.013 (0.045)	-0.007 (0.022)
Make few decisions alone (d)	0.229 (0.141)	0.189** (0.068)
Make most or all decisions alone (d)	0.376** (0.141)	0.336*** (0.068)
Have fiscal policies manual (d)	0.025 (0.118)	0.173** (0.057)
Have operating expenses policy (d)	0.119 (0.113)	0.015 (0.055)
Have audit committee (d)	0.130 (0.098)	0.106 (0.047)
N	409	407
Adjusted R-squared	0.0668	0.1459

Note: Regressions were also controlled for tenure of respondent at the organization and age of the organization through a fourth degree polynomial of both variables, as well as controlled for presence of a capital expenses policy through a dummy variable

Statistically significant at \* p<0.05 \*\* p<0.01 \*\*\* p<0.001

(d) indicates discrete changes in dummy variable from 0 to 1

<sup>^</sup> Test Scale: Responses to financial literacy questions. 0- At least one incorrect, rest of responses "don't know", 1- All three responses were "don't know", 2- One correct, 3- Two correct, 4- All correct

<sup>^^</sup> Self-reported knowledge about overall financial management. 1- Novice, 2- Knowledgeable, 3- Expert

<sup>†</sup> Advanced degree refers to respondent having a Master's degree in accounting, business administration, finance or other related degree

Reference group is female respondent without a Master's degree in finance or equivalent, rarely makes financial decisions alone, organization has no written financial policies or audit committee

Having an advanced degree had a significant positive effect on respondents' financial literacy as measured by the survey questions, but did not seem to have a significant relationship with their self-reported knowledge of financial practices. We see further

evidence that total annual revenue of organizations and their financial literacy are significantly correlated. Organizations with higher revenues reported that they were more knowledgeable on financial practices, than those organizations with lower annual revenues. Those respondents who reported having greater freedom to make financial decisions independently also tended to be more financially literate.

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## Appendix

### Organizations by subsector

	Count	Percent
Civic/ Environment	73	14.2
Health/ Human services	341	66.3
Education	46	9
Arts	54	10.5
Total	514	100

### Compared to 2008, the total charitable donations for 2009

	Count	Percent
Decreased by more than 15%	57	12
Decreased by less than 15%	90	19.2
Stayed the same	137	29.1
Increased by less than 15%	64	13.5
Increased by more than 15%	123	26.2
Total	471	100

### What is the average percentage of income your organization received from each of the following sources in 2009?

	Average percent
Foundations	15.2
Individual contributions	25.4
Earned income	24.4
Corporate support	11.2
Government sources	32.8

### How many board members currently serve on your board? (Please include only those with full voting privileges)

	Count	Percent
Less than 10 members	77	18
10 to 14 members	109	25.4
15-19 members	117	27.3
20-plus members	126	29.4
Total	429	100

### How often did the audit committee meet during the most recently completed fiscal year?

	Count	Percent
Once a year	41	25.2
Twice a year	64	39.3
Three times a year	43	26.4
More than four times a year	15	9.2
Total	163	100

**How many internal and external members serve on the audit committee (different than finance committee)?**

<b>Internal</b>	Count	Percent
No members	7	4.4
One to two members	57	35.9
Three to four members	73	45.9
Five members plus	22	13.8
<b>Total</b>	<b>159</b>	<b>100</b>

<b>External</b>	Count	Percent
No members	44	29.3
One to two members	61	40.7
Three to four members	37	24.7
Five members plus	8	5.3
<b>Total</b>	<b>150</b>	<b>100</b>

**How many Certified Public Accountants does your audit committee have?**

	Count	Percent
None	42	25.5
One	77	46.7
Two	32	19.4
Three	11	6.7
Four	3	1.8
<b>Total</b>	<b>165</b>	<b>100</b>

**What is your highest level of education?**

	Count	Percent
High school graduate	25	5.9
Bachelor's degree	172	40.7
Master's degree	192	45.4
PhD/specialized degree	34	8
<b>Total</b>	<b>423</b>	<b>100</b>

**How many courses and/or training have you taken in accounting, economics, operations, and financial management?**

	Count	Percent
None	46	11
One to two courses	99	23.7
Three to four courses	70	16.8
More than five courses	203	48.6
<b>Total</b>	<b>418</b>	<b>100</b>

**How many full-time employees have the primary responsibility of handling the organization's accounting and fiscal management?**

	<b>Count</b>	<b>Percent</b>
Only myself	83	19.7
2 to 3 employees	242	57.5
4 to 5 employees	55	13.1
More than 5 employees	41	9.7
<b>Total</b>	<b>421</b>	<b>100</b>

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<sup>1</sup> President's Advisory Council on Financial Literacy (2008). 2008 Annual Report to the President. The 16-member Council includes representatives of nonprofits, private sector companies, academia, state government and other organizations dedicated to the delivery of financial education. [http://www.treasury.gov/resource-center/financial-education/Documents/PACFL\\_ANNUAL\\_REPORT\\_1-16-09.pdf](http://www.treasury.gov/resource-center/financial-education/Documents/PACFL_ANNUAL_REPORT_1-16-09.pdf)