Alliance for the Chesapeake Bay

Date: October 10, 2018

To: Board of Directors

From: Finance Committee

Topic: Report on Audited Financial Statements

The purpose of this memo is to discuss the results of the 2017 audited financial statements and auditor findings. We discussed this as a committee on two occasions and Brian Macnamara met with Mike Davis, Anderson, Davis & Associates, CPA, during the Taste event in October.

Financial Statements - The 2017 financial statements received an unqualified opinion from our auditors which is considered a clean opinion. The audit team reviews and tests management's accounting processes and controls to gain reasonable assurance that the financials are materially correct. Consistent with prior years they provide a management letter in which they note any concerns or findings. The sole finding this year is related to the timing of recording expenses that required an additional accounts payable accrual of approximately $158,000. In prior years management had recorded expenses based on the date of the invoice rather than the date the services were incurred. The impact of the proposed change was to record an accrual for expenses, which increased accounts payable for 2017. The impact of this adjustment is a decrease in current net assets, however, as grant activity is generally constant throughout the year we believe this represents a timing difference and not a permanent reduction in net assets.

Decrease in Net Assets – One area of concern for the Committee was the decrease in net assets of approximately $765,000. After discussion with the Alliance Staff and Mr. Davis we believe that it was primarily the result of three factors: 1) The accounts payable accrual of $158,000; 2) The timing of recording revenues from outstanding grants of approximately $366,000; and, 3) The $224,000 loss related to poor recovery from outstanding grants.

Accounting Adjustment - As discussed above, the change in accounting process effectively pushed expenses back into 2017 increasing accounts payable and decreasing net assets. However, we believe given the relative consistency of revenues and expenses over the past few years that this portion of the deficit should be reversed as the Alliance submits the invoices to the granting agencies for reimbursement. It should be noted that this is an estimate as overall revenues and expenses have been increasing, however if we assume that the Alliance's operating margins remain relatively constant the net impact should be reversed.

Revenue Recognition – Consistent with accounting policies and good business practices, the Alliance recognizes revenues when there is certainty of the recovery of the costs and it invoices the granting agency. While the timing of reimbursement varies and is grant specific, generally the Alliance is required to invoice in arrears for expenses incurred. Accordingly, funding the activity of the Alliance (primarily salary, benefits and operating expenses) will be incurred prior to the recovery of those costs. For a limited number of grants, the Alliance receives funds in advance and provides the granting agencies with a reconciliation of costs incurred. Based on discussions with the Alliance staff and review of the first quarter financial reports for 2018, we observed an increase in net assets of approximately $366,000, which we believe is consistent with invoicing (i.e. revenues) for reimbursement of these grants. We observed further improvements in net assets in the second quarter albeit not as significant.

Reimbursement of Expenses under Grants – Consistent with prior years operations and as discussed at length at the Board meeting in April 2018, approximately 95% of Alliance revenues in any year are directly attributable to allowed reimbursements under grants. Generally, the grants provide that direct employee costs (e.g. wages and benefits) will be reimbursed at an agreed upon rate, which at a minimum should cover the costs of Alliance staff who are directly involved in a project. For example, if the cost of each Alliance employee is approximately 125% of their salary we would invoice the granting agency that amount which is referred to as the "fully loaded" employee cost. Further, many grants allow the Alliance to request reimbursement at a rate greater than the fully loaded cost of an employee. For example, the current year federal grants provide a rate of approximately 140% of an employee's salary. This is critical to funding Alliance operations as the cost of an employee naturally includes the cost of its physical space (i.e. rent, utilities, equipment, etc.) as well as overhead associated with administering the organization. To illustrate this point if we assume an employee's fully loaded cost is $125 then we would expect to recover $175 (140% of $125 = $175). The additional $50 is then available to cover operating office costs. Implicit in understanding this process is that employees for each state office must be able to allocate substantially all their time to specific grants in order to qualify for this reimbursement.

During 2017, the Alliance did not recover approximately $224,000 of employee costs under several grants. We believe the primary reasons for this loss are: 1) Eligible employees not allocating all or substantially all their time to grant projects, and 2) Grants whose reimbursement rates are less than the fully loaded costs of employees. This is a serious issue as these costs must then be recovered from unrestricted funds such as those raised by donations or the Taste event. The Committee's understanding is that Executive Director Kate Fritz has taken several steps to address both issues. First, she has instructed all state-office employees to charge all their time to grants where appropriate. Second, she instituted a finance team review of all grants prior to acceptance to ensure that most grants applied for will at a minimum cover the fully loaded costs of Alliance employees. Notwithstanding this policy, it will be at the Executive Director's option to work with agencies or on specific projects that she feels are critical to the Alliance's mission in the broader Chesapeake community. Brian Macnamara discussed both policy changes with Mike Davis who noted that this is consistent with best business practices for not-for-profits.

Conclusion – The Finance Committee believes that the 2017 audited financial statements accurately reflects the position and operations of the Alliance. Further, we believe the business processes instituted by the Executive Director should ensure that future grants, and where possible existing grants, will be appropriately invoiced to cover Alliance costs. We will continue to monitor the results of this process improvement with the Executive Director and update the Board as appropriate.