

BOARD GOVERNANCE TRAINING

Nonprofit Financial Group

May 13, 2014



Steve Bass
Principal



Agenda

- | | |
|---|-----------|
| PART 1: Defining Accountability and Fiduciary Responsibility | 3 |
| <i>The purpose of this session is to understand the legal and ethical requirements of serving as a board member</i> | |
| PART 2: Governance vs. Management | 24 |
| <i>The purpose of this session is to understand the difference between governance and management</i> | |
| PART 3: Next Steps: Value Added Fiduciary Work | 36 |
| <i>The purpose of this session is to examine the next steps in shifting from management to governance, specifically to examine value added board actions and inquiries.</i> | |
| PART 4: Characteristics of Nonprofit Financial Health | 41 |
| PART 5: Finding the Characteristics of Financial Health in your Financial Statements | 44 |



Part One:

Accountability and Board Fiduciary Responsibility

Defining Accountability

Nonprofit board members are required to:

- Operate with a clarity of purpose
- Maintain legal knowledge
- Maintain ethical behavior that extends beyond the requirements of the law
- Conduct regular self-evaluation of mission, programs, and operating policies
- Maintain responsibility for fiscal oversight

Purpose of the Governing Board

- Three purposes for the board of directors
 - To register as a tax-exempt corporation
 - To provide organizational oversight
 - To maintain accountability to the public and the law
- A governing board must ensure that:
 - The organization provides a product or service that reflects the community's need
 - The organization is healthy – financially, managerially, and programmatically

Governance Responsibilities

- Establishing mission and philosophy
- Planning
- Selection and supervision of top management
- Ensuring adequate resources and managing them effectively
- Setting policies to effectively guide operations and programs
- Reviewing financial and programmatic performance as compared to objectives

Governance Responsibilities (cont'd)

- Organization of the board to work effectively
- Recruitment and orientation of new members
- Advocacy for the organization in the community
- Ensuring legal and ethical integrity

What Does the Law Require?

- Duty of Care
 - Diligence and attentiveness to board responsibilities. Act as “an ordinarily prudent person” would “in a like position and under similar circumstances.”
- Duty of Loyalty
 - Faithful pursuit of the interests of the organization rather than personal interests or the interest of another person or organization.
- Duty of Obedience
 - Act with fidelity, within the bounds of law generally, to the organization’s mission.

Duty of Care

- Attend meetings and actively participate in the work of the board
- Scrutinize the work of committees having authorization of the board
- Participate in board actions. If you are there, you are responsible
- Know the books and records
- Protect the organization's assets consistent with donor restrictions and legal requirements

Duty of Care (cont'd)

- Assist the organization in obtaining adequate resources
- Honor your duty to investigate and report potential theft or mismanagement

Duty of Care (cont'd)

- Ensure financial accountability:
 - Oversee the organization's chief executive
 - Check that resources are used prudently
 - Implement procedures to ensure accurate records
 - Ensure segregation of duties
 - Maintain internal controls
- Document decision-making in board minutes

Duty of Loyalty

- Avoid conflicts of interest or the appearance of such conflict. If questions arise, the burden of proof that no conflict exists lies with the director
- Establish a written policy on avoiding conflicts of interests
- Do not lend money to a director or the director's family unless the board deems it will benefit the corporation

Duty of Loyalty (cont'd)

- Do not divert a corporate business opportunity for your own personal gain
- Adhere to the rules of the Internal Revenue Code regarding self-dealing
- Do not take free “gifts” from the organization for your personal benefit

Duty of Obedience

- Ensure the organization remains obedient to its central purpose
 - Be familiar with state and federal statutes and laws related to the organization
 - Comply with deadlines for all local, state, and federal filings
 - Be familiar with the organization's governing documents and follow the provisions of those documents
 - Where appropriate, obtain opinions of legal counsel or accountants

Fiduciary Responsibility

Financial oversight is a core responsibility of the board

That means that ALL board members:

- Have equal and shared fiduciary responsibility for the organization
- Understand the content and significance of financial statements and audit

Fiduciary Responsibility

- Ensure the protection and appropriate use of the organization's assets
- Establish program revenue and expense objectives which are consistent with the mission of the organization
- Insist on income-based spending
- Thoroughly discuss and adopt an annual budget that reflects the financial objectives and strategies of the organization before the beginning of its fiscal year

Fiduciary Responsibility (cont'd)

- Review financial statements regularly and compare them to budget. Ensure that you account for significant variances and require timely course adjustments as needed
- Ensure that strong and appropriate internal financial controls, processes, and practices are in place
- Establish appropriate financial policies to guide organization operations
- Where possible, establish an operating reserve to finance cash shortfalls and program growth

Fiduciary Responsibility (cont'd)

- Assess annual audit implications and approve action plans to strengthen performance
- Establish and monitor a system to ensure that the organization is in compliance with all relevant financial laws and regulations
- Approve non-routine contractual obligations as defined by approved board expenditure authorization policies
- Establish adequate risk management mechanisms

Treasurer Responsibilities

- Provide the eyes and ears of the board in the finance area
- Report to the board the financial condition of the organization on a regular basis
- Monitor internal controls, financial planning
- Ensure that timely, accurate financial information is presented to the board in a clear and concise manner

Finance Committee Responsibilities

- Provide monthly review of financial statements
- Oversee financial operations:
 - Budgeting
 - Policy development
 - General financial planning – current and long-term
- Be alert to signs of financial problems
- Risk assessment
- Investment
- Audit oversight

Audit Responsibilities

- Select audit firm and define service expectations
- Discuss scope and timing of work with auditor
- Respond to audit findings and recommendations
- Present annual financial statements
- Review conflicts between auditors and management
- Review audit letters that are received in addition to the audit report

Executive Responsibilities

- Carry out board policy and directives
- Administer internal controls
- Monitor financial goals and objectives
- Process financial information
- Prepare budgets and financial information
- Provide accurate, timely and meaningful information
- Keep the board appropriately informed
- Maintain key relationships (sponsor, community, etc.)

Know and Use Your Available Resources

- Washington State Legislature:
www.leg.wa.gov
- Washington State Secretary of State:
www.sos.wa.gov/corps/NonprofitCorporations.aspx
- Washington Nonprofits:
www.washingtonnonprofits.org
- Washington Attorney General:
www.atg.wa.gov
- GuideStar:
www.guidestar.org



Part Two:

Management vs. Governance

Governance

In the nonprofit setting, the purpose of governance is to “ensure, usually on behalf of others, that an organization achieves what it should achieve, while avoiding those behaviors and situations that should be avoided.”

- John Carver
Boards That Make A Difference, 2006

Governing Functions

- Strategic Direction – setting a direction for the organization that reflects its constituents needs
- Resource Development – developing financial resources that support program activities
- Financial Accountability – managing financial resources that ensure honesty and cost-effectiveness
- Leadership Development – developing the human resources that lead the organization today and in the future

Management Functions

- Program Planning and Implementation – taking the strategic directions to the next level of detail and putting it into action
- Administration – ensuring the effective management of the details behind the program

Understanding Board and Staff Roles

Answering two important questions...

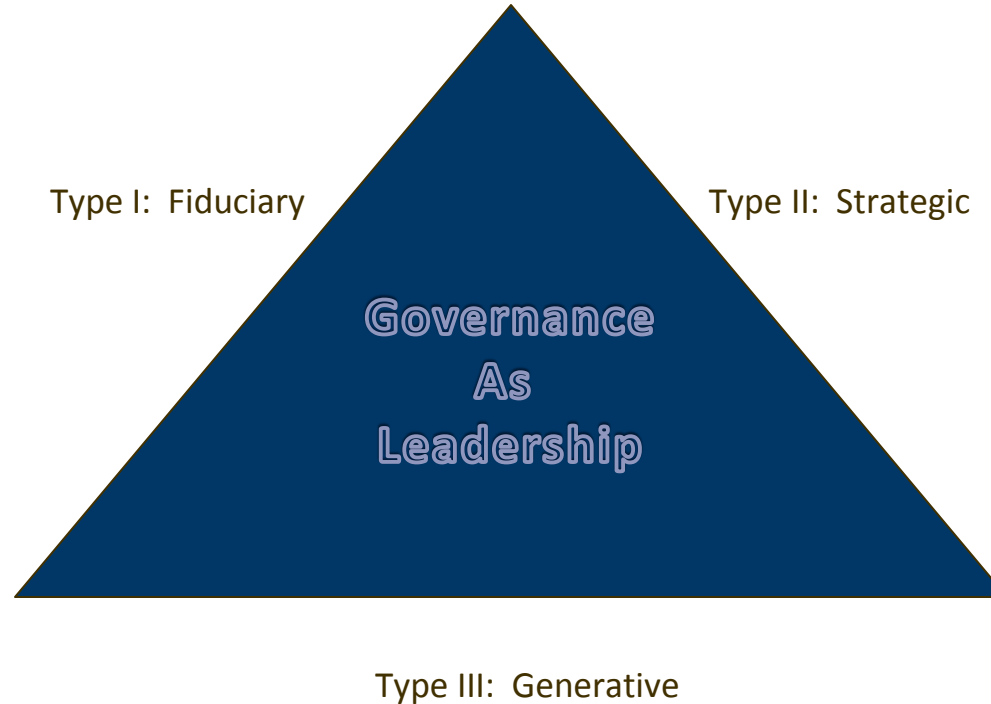
- How to determine distinct roles for board and staff so that each has a clear job description
- How to engage board and staff in a complementary manner to provide organizational leadership

Determining Different Roles

- Governance is the ultimate responsibility of the board, while the responsibility of the staff is management.
- Rather than seeing the nonprofit board's job as a function of *management*, it is *first and fundamentally* a responsibility for *ownership*.
- Board should ask, in regards to programs and initiatives, "Why are we doing this, rather than, how can we do it?"

Governance Triangle

Three modes of governance based on best practices of organizations and behavioral theory



Type I: Fiduciary Mode

- Fiduciary accountability, integrity and oversight

“Essential but if that is all a board does, its focus is to prevent trouble rather than promote success”

- Richard Chiat, William Ryan and Barbara Taylor
Governance as leadership: reframing the work of nonprofit boards (2006)

Oversight vs. Inquiry

Oversight Questions

Can we afford it?

Is the budget balanced?

Is it legal?

Inquiry Questions

What is the opportunity cost?

Does the budget reflect our priorities?

Is it ethical?

Type II: Strategic

- Beyond annual strategic planning to continuous strategic thinking
 - Calls for a different relationship with management than Type I
- “Until a board learns to use ideas rather than plans to drive strategy, the full range of the board members talents will be vastly under utilized.”
- “Boards are better suited to think together than to plan together, to expand the essence of a great idea, rather than elaborate the details of a plan”

- Richard Chiat, William Ryan and Barbara Taylor
Governance as leadership: reframing the work of nonprofit boards (2006)

Strategic Management

Oversight Questions

How can we maintain market share?

How much debt capacity do we have?

Inquiry Questions

Are we in the right markets?

Where should we invest or divest?

Type III: Generative

- Drivers for continually moving the organization forward
- REAL WORLD EXAMPLE
 - Problem – voluntary turnover of staff
 - Technical solution – increase compensation
 - Generative solution – create a great place to work for professional staff where quality work, not money is the decisive factor.



Part Three:

Value Added Fiduciary Work

General Trends in Board Operations

From...	To...
Enjoying the public trust	Fulfilling the duty to be accountable to the public
Allowing individuals to participate at their discretion	Understanding the obligations to govern effectively
Creating a loose federation of common interests	Maintaining a compact group that is aware of its cultural and political dynamics
Seeking comrades	Finding colleagues
Constituting the Board in large numbers to ensure involvement	Downsizing to ensure effectiveness
Recruiting new Board members based on personal relationships or emotional commitment to the cause	Recruiting selectively based on skills and influence as they relate to the organization's strategic focus and direction
Agreeing to be a Board member while unclear about roles and expectations	Being clear about one's stewardship responsibilities

General Trends in Board Operations (cont'd)

From...	To...
Using meetings as the only avenue for decision making	Employing varied means of communication
Receiving and reviewing vast amounts of information	Receiving and reviewing targeted and strategic information related to key issues
Preparing agendas that reflect immediate past activities	Preparing highly structured agendas to address key organizational strategies
Meeting monthly	Meeting less often and, when needed, on an ad hoc basis to focus on key strategic issues
Making decisions as a committee of the whole	Organizing effective committee structures to recommend policy to the Board
Providing financial oversight with a small, closed group	Sharing relevant financials with the entire Board
Being uninsured and unaware of the potential risks and obligations	Having sufficient insurance and a risk management plan

Responsibilities of a Board Member

- Ensure the Future
- Ensure the Mission
- Ensure Effective Governance
- Ensure Effective Operations

Value Added Fiduciary Work

OVERSIGHT	INQUIRY
Due diligence	Holds what in trust for whom?
Scandal free	Do we have the proper safeguards in place?
Compliance	What voluntary measures can we take to earn trust?
Clean audit	What can we learn from audit?
Can we afford it?	What is the opportunity cost?
Balanced budget	Does the budget match our priorities?
Risk management	Do we take sensible risks?
Programs meet market	Do our new programs serve mission?
Is it legal?	Is it ethical?



Part Four:

Characteristics of Nonprofit Financial Health

Financially Health Nonprofits

1. Have sufficient financial resources to ensure stable programming
2. Have a ready source of internal cash, or access to cash, available in time of shortfalls
3. Are committed to income-based spending
4. Retain, at the end of each year, positive cash and net assets

Financially Health Nonprofits (cont'd)

5. Have accumulated surpluses which are greater than the current year's deficit if there has been a deficit for the year
6. Have established, or have specific plans to establish, an operating reserve to finance cash shortfalls and program growth
7. Have board and management that hold themselves responsible for the financial stability of the organization



Part Five:

Finding the Characteristics of Financial Health in your Financial Statements

Financial Indicators

1. Financially healthy nonprofits have sufficient financial resources to ensure stable programming

INDICATOR	DEFINITION	WHAT IT TELLS ME	WHERE I FIND IT
Net Asset Position	Total assets minus total liabilities	A positive number represents accumulated surpluses / solid financial performance	Statement of financial position (balance sheet)

Financial Indicators

1. Financially healthy nonprofits have sufficient financial resources to ensure stable programming (cont'd)

INDICATOR	DEFINITION	WHAT IT TELLS ME	WHERE I FIND IT
Permanent Capital	Funds that have been restricted by a donor. The restriction usually prohibits use of the "corpus"	Organization has a supporter who believes in it enough to make a permanent investment.	Statement of financial position (balance sheet)
Semi-permanent Capital	Funds that have been restricted or designated by the board	Leadership recognizes the need for working capital	Statement of financial position (balance sheet)

Financial Indicators

2. Financially healthy nonprofits have a ready source of internal cash available in times of shortfalls

INDICATOR	DEFINITION	WHAT IT TELLS ME	WHERE I FIND IT
Working Capital	Current assets minus current liabilities	How much of the assets are liquid and available for day to day needs	Statement of financial position (balance sheet)
Current Ratio	Current assets divided by current liabilities	Proportion of liquid assets to the claims on those assets (should be > 1)	Statement of financial position (balance sheet)

Financial Indicators

2. Financially healthy nonprofits have a ready source of internal cash available in times of shortfalls (cont'd)

INDICATOR	DEFINITION	WHAT IT TELLS ME	WHERE I FIND IT
Quick Ratio	Cash + accounts receivable ÷ current liabilities	More conservative than current ratio for showing liquidity	Statement of financial position (balance sheet)
Cash on Hand to Current Liabilities Ratio	Cash divided by current liabilities	Measures liquidity strictly on the basis of cash on hand	Statement of financial position (balance sheet)

Financial Indicators

3. Financially healthy nonprofits are committed to income-based spending

INDICATOR	DEFINITION	WHAT IT TELLS ME	WHERE I FIND IT
Unrestricted Surplus / (Deficit)	Income less expenses = surplus (deficit if negative)	Positive number means the organization lived within its means for the time period shown.	Statement of activities

Financial Indicators

4. Financially healthy nonprofits retain, at the end of each year, positive cash net assets

INDICATOR	DEFINITION	WHAT IT TELLS ME	WHERE I FIND IT
Positive Cash Net Assets	Cash + receivables – temporarily restricted net assets > zero	Positive number means the organization has enough liquid assets to cover what has already been received in temporarily restricted funds, with some left for operational needs.	Statement of financial position (balance sheet)

Financial Indicators

5. If there has been a deficit for the year, financially healthy organizations have accumulated surplus which are greater than the current year's deficit

INDICATOR	DEFINITION	WHAT IT TELLS ME	WHERE I FIND IT
Net Asset Position	Total net assets at end of year	Positive number means there are enough net assets at the beginning of the year to "fund" the current year deficit, if there is one.	Statement of financial position (balance sheet)

Financial Indicators

6. Financially healthy organizations have established, or have plans to establish, an operating reserve to finance cash shortfalls and program growth

INDICATOR	DEFINITION	WHAT IT TELLS ME	WHERE I FIND IT
Presence / Absence of a Reserve	Assets include a cash reserve or similar fund, and net assets shows the same fund	The organization's leaders have acted upon a perceived need to dedicate resources to financial stability	Statement of financial position (balance sheet)

Financial Indicators

Other helpful indicators

INDICATOR	DEFINITION	WHAT IT TELLS ME	WHERE I FIND IT
Debt / Net Assets Ratio	Loans + notes payable divided by net assets	Indicates how much debt the organization carries in proportion to its net worth. The higher the %, the more the organization relies on borrowed money for its ongoing operations.	Statement of financial position (balance sheet)

Financial Indicators

Other helpful indicators (cont'd)

INDICATOR	DEFINITION	WHAT IT TELLS ME	WHERE I FIND IT
Contributions to Total Revenue Ratio	Contributed income divided by total revenue	Measures the proportion of revenue that comes from grants, donations, other charitable contributions. A diverse mix is ideal.	Statement of activities

Financial Indicators

Other helpful indicators (cont'd)

INDICATOR	DEFINITION	WHAT IT TELLS ME	WHERE I FIND IT
Program to Total Expenses Ratio	Program expenses divided by total operating expenses	Measures the proportion of expenses used to support programming vs. how much is spent for general management and fundraising.	Statement of activities



Steve Bass

Principal

steve.bass@CLAconnect.com

425-250-6016