Do Your Board Members Know Their Fiduciary Responsibilities?

A surprising number of board members don't fully understand their legal and ethical duties. Such ignorance can put your organization at risk.

By Nat Bartholomew

Nonprofit boards are legally accountable for the organizations they serve. Yet many board members are unprepared for their fiduciary obligations.

Do your board members know how to fully embrace their duties regarding organizational integrity, strategy, resource management, and advocacy? Do they scrutinize the books and records to protect the organization, overseeing the executive staff and resources, as required? Take time to review and update board policies and procedures to make sure your directors are informed and empowered to uphold their fiduciary roles.

Defining Fiduciary Responsibility

Fiduciary responsibility is the highest standard of legal duty. People entrusted with such obligations must do more than adhere to all laws and regulations. They must also live up to the highest possible ethical standards. They must never let their personal interests conflict with this ethical duty.

For this reason, board members must be actively engaged as true leaders, overseeing management, recruiting new members, ensuring adequate resources, advocating for the organization, and guiding financial and programmatic performance. These leadership responsibilities fall within three legal areas:

- **Duty of care** refers to the diligence of board members in protecting the organization. Board members automatically agree to participate in meetings, help obtain new resources, and maintain financial accountability, including averting theft or mismanagement.
- **Duty of loyalty** means that the board places the interests of the organization above their own individual interests. This includes avoiding conflicts of interest and adhering to policies and laws governing self-dealing.
- **Duty of obedience** requires adherence to the nonprofit's central purpose and the state and federal statutes related to governing the organization. Maintaining legal documents and complying with regulations fall within this area of responsibility.

Financial oversight is the board's core imperative. All board members are required to share in fiscal responsibility for the organization. As leaders, board members are required to perform these fiscal duties:

- **Ensure the protection and appropriate use** of the organization's assets.
- **Establish mission-consistent revenue** and expense objectives.
- **Understand** the content and significance of the organization's financial statements and tax filings.
- **Insist** on income-based spending (spending within the organization's means). The organization mustn't pay out more in any given year than the amount taken in.
- **Adopt a fiscally responsible annual budget** before the fiscal year begins.
- **Review** financial statements regularly and compare them to the budget.
- **Design** internal financial processes, controls, and practices.
- **Develop and oversee** appropriate financial policies.
- **Establish an operating reserve** for cash shortfalls and program growth.
- **Assess** annual audit implications, and approve performance plans.
- **Create and monitor a compliance system** for laws and regulations.
- **Approve non-routine contractual obligations** as defined by board policies.
- **Develop adequate risk management** mechanisms.

The board treasurer agrees to uphold the requirements listed above, and in addition:

- **Serve as the board representative** for the organization's finances.
- **Report to the board on the organization's financial condition** and results from operations.
- **Monitor** internal controls.
- **Be sure that the board receives** accurate and timely financial information.

The board's finance committee has the responsibility to:

- **Review** financial statements.
- **Be alert to potential problems** and risks.
- **Manage the audit process** (if not delegated to the audit committee). This includes selecting an auditing firm and overseeing their work.
- **Oversee** the organization's investments. This means creating an investment policy. It may also include forming an investment committee to ensure best practices in monitoring and reporting.
- **Monitor** the budget, financial performance, financial condition, financial policies, and financial planning (budgets, projections, and strategic plans).

Appreciating the Difference between Governance and Management

Governance is the ultimate responsibility of the board. Management is the responsibility of the executive staff. The board's role is foremost a responsibility of ownership. Board members continually ask why the organization undertakes certain initiatives, whereas the CEO and managers focus on how to undertake initiatives in addition to why.

Six primary functions fall within the board's purview:

- **strategic direction** that aligns with the mission and vision
- **resource development** that supports the programs
- **financial accountability** that ensures resources are managed effectively and appropriately
- **leadership development** for organizational sustainability
- **program planning and implementation** that inspires action
- **administration that ensures effective management** of the organization.

Ultimately, it's up to the board and executive staff to determine, communicate, and abide by the distinct roles set for board members and management. The more clarity the board provides, the smoother the organization's operations will be.

Understanding Financial Fundamentals

In addition to outlining board roles and responsibilities, it's important to provide board members with the fundamentals of financial accountability. While directors may believe they understand the basics of finance, an orientation allows them to refresh their knowledge and become re-engaged in financial oversight. Nonprofit finance can be quite different from personal or corporate finance; board members often struggle with these nuances.

Every board member should understand these five financial basics:

1. **There are two types of income:** support (donated) and revenue (earned).
2. **Financial information is based on periods of time** reflected in financial data: past (financial statements), future (budget), and present (cash-flow analysis).
3. **Numbers are meant to be compared:** actual vs. current-year budget, actual vs. prior period year actual, and actual vs. five-year trend.
4. **Anticipation is the key to financial stability:** Management needs to make adjustments if revenues aren't flowing as expected.
5. **Sustainable financial health is essential for the effective delivery** of programs and services.

Board members must be attentive to any red flags associated with these financial basics. The board should receive financial information from staff in advance of every board meeting and be prepared to ask any questions that come to mind.

Financially healthy nonprofits have the following:

- **sufficient resources** and cash flow
- **positive cash and net assets** at year end
- **recurring surpluses** and operating reserves.

"Anticipation is the key to financial stability."

Reading Financial Statements

When reading financial documents, it's imperative to understand the following:

Income falls within three categories:

- **Unrestricted support** is income free of all donor-imposed restrictions and available for use by the organization according to its mission and operations. To donors, the term "unrestricted" means the funding may be used for any program or service of the organization as general operating funding.
- **Temporarily restricted support** must be held for use during a specific period or for a specified purpose or activity.
- **Permanently restricted support** typically must be maintained in perpetuity in accordance with the donor's intent. With a few exceptions, the organization can use only the income from the invested support.

Expenses are of two main types:

- **Direct expenses** are assigned or allocated to specific activities, such as rent, salaries, or postage for a specific program or activity.
- **Indirect expenses** include overhead, such as rent, accounting, insurance, and other costs that benefit the entire organization. Indirect expenses are often allocated back to programs and activities on a percentage basis.

The statement of financial position, or balance sheet, provides a snapshot for the organization's financial position at a given point in time. It covers assets, liabilities, and net assets (representing the difference between total assets and total liabilities). The statement of financial position provides the following indicators of a nonprofit's financial health:

- **Net assets** are the accumulation of surpluses or deficits the organization has achieved since it began operating. For sustainability, surpluses must historically exceed deficits.
- **Net asset position** is the organization's total assets minus its total liabilities. A positive number means there are net assets available to fund a current year deficit.
- **Working capital** is defined as the organization's current assets minus its current liabilities. The amount illustrates the liquidity of assets available for daily operations.
- **Current ratio** represents current assets divided by current liabilities. This amount shows the proportion of liquid assets compared to the claims on those assets.
- **Quick ratio** is the organization's cash plus its accounts receivable divided by its current liabilities. This number provides a more conservative view of liquidity than the current ratio.
- **Cash on hand/current liabilities ratio** is the organization's available cash divided by its current liabilities. This ratio measures liquidity strictly on the basis of obtainable cash.
- **Cash reserve** is the amount of money on hand to meet unanticipated needs. A large amount shows that leaders are committed to financial stability over the long term.

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- **Debt to net assets ratio** includes loans plus notes payable, divided by net assets. The higher the percentage of debt to net worth, the greater dependence on loans for operational needs.

The statement of activities shows the organization's financial activities from the start to the end of the fiscal year. This statement covers sources and amounts of income, how income was spent, and either a surplus or deficit at year end. The statement of activities provides these indicators of financial performance:

- **Unrestricted surplus** is income minus expenses. A positive number means that the organization has lived within its means for the period reflected.
- **Unrestricted deficit** is income minus expenses. A negative number shows that the organization is not living within its means.
- **Contributions to total revenue ratio** is the organization's contributed income divided by its total revenue. This ratio measures the proportion of revenue from grants, donations, and contributions, with diversity as the goal.
- **Program to total expenses ratio** is defined as the organization's program expenses divided by its operating expenses. This ratio measures the proportion of expenses used to support programming vs. management and fundraising.

Financial statements tell a story. It's the job of management to interpret that story. It's the job of governance to question it. Understanding a few basic ratios and terms will go a long way in arming board members to do just that.

Empowerment, Trust, & Verification

So what can board members gain by understanding financial terms and knowing how to read financial statements? Namely, "empowerment"—they become empowered to operate as true leaders of the organization and actively practice their governance responsibilities.

Trust is essential to the nonprofit model. But trust without verification can blind board members to red flags—and potential problems for which they will be held accountable by constituents and the community.

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Minimizing Risk, Maximizing Reward

To assure that your board members fully understand the details of their fiscal duties, see these articles at www.NonprofitWorld.org/members:

Are Your Cost Allocations Up-to-Date? (Vol. 25, No. 2)

The Yin and Yang of Operating Reserves: What You Need to Know (Vol. 27, No. 1)

Investment Guidelines (Vol. 13, No. 1)

Good Cash Management Shows Good Stewardship (Vol. 25, No. 6)

Don't Forget Your Indirect Costs! (Vol. 14, No. 5)

Are You Financially Empowered? A Quiz (Vol. 15, No. 1)

Nonprofits without Audit Committees Risk Disaster (Vol. 22, No. 2)

Also see Learning Institute programs on-line: Board Governance (www.NonprofitWorld.org/LearningInstitute).

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