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# The Dirty Little Secret of NonProfit Boards

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**Warning:**
The following is a topic boards do NOT discuss openly. If you feel this article is applicable to your organization, you may want to make copies for your whole board, and suggest that this become a topic for policy discussion, rather than singling out the individuals to whom it applies. Because in the end, it applies to everyone.

As Seen In CharityChannel NonProfit Boards & Governance Review

**Fact:**
On virtually every board of every NonProfit throughout the world, there are board members who do not understand how to read a balance sheet, a profit & loss statement, or any of the other financial data boards typically review and vote on. At best, your board likely contains at least a few such members. At worst, you have a majority of board members who do not have a clue about the financial statements and reports that are regularly placed in front of them.

The consequences of this widely accepted (and completely ignored) truth are many.

- Board members who vote to approve the budget, but don't really understand the budget.
- Board members who make decisions on whether or not to hire a new staff person, but don't understand whether or not the organization can afford that new position.
- Board members who vote on which fundraising approach to pursue, but couldn't do a cost/benefit analysis to determine if that really is the best choice.

Most people would agree that it is bad policy to allow individuals to make decisions about things they do not understand. Yet every day, board members make countless decisions without understanding the financial ramifications of those decisions.

And so, herewith, some policy recommendations to help your board move beyond financial ignorance, and then some very basic first-step information, to spark your board's thinking about the financial reports they discuss and vote on every month.

**Policy Recommendations:**
1) Among your organization's financial policies (you do have financial policies, don't you?) should be a policy that all board members will evidence a knowledge of basic financial information. They should evidence that they understand what a balance sheet is, what a profit and loss statement is, what a budget is. Yup - they should take a test and prove they know it! That leads to the second recommendation.

2) Financial training should be part of your orientation program - with a test at the end. Board members don't need to be budding CPA's, but if they can't answer basic financial questions about the organization's health, they cannot govern - period.

3) Consider changing your bylaws to prohibit anyone from voting if they haven't evidenced basic financial understanding. Really. If they can't determine how much is in reserves (or what that means), or they can't discern if $10,000 is a lot or a little for your organization, they shouldn't be making decisions!

### Now Some Finance/Economics Basics

If these concepts are foreign to anyone on your board (maybe even you!), it is time for your board to get some training - and fast!

### Overall Economics and Basic NonProfit Information:

- What does it mean that your organization is NonProfit? Is the organization allowed to show a profit? What happens if you do?
- Where do most funds come from in the NonProfit sector? Are they mostly from grants?
- What does "Opportunity Cost" mean? How does that affect your board's decision-making?

***True Story:*** At the end of their fiscal year, a small nonprofit arts group had funds left over in their account. The board voted to donate every penny of those funds to another charitable organization, because they thought a NonProfit wasn't allowed to have funds left over.

***Some Economics / NonProfit Basics:***
An economy is a dynamic system where forces play against each other. Economics has more to do with understanding how the world works and how decisions affect other decisions, than it has to do with numbers.

A basic knowledge of overall economics will help you put your organizational decisions into the bigger context of the economy of your community, your state, your world. It will also help you understand how one decision affects others your organization will have to make. How do NonProfits relate to other parts of the economy? What are NonProfits allowed to do / not allowed to do? Without this basic information, your board simply cannot govern responsibly.

### Balance sheet:

- What is the balance sheet? What story does it tell?
- Are assets and liabilities good or bad?
- What is a debt/equity ratio? What does it tell about the organization? Can you find the debt/equity ratio on your organization's balance sheet?

***True Story:***
An organization had gone through financial difficulties, but those troubles were now in the past. Even though their balance sheet showed a strong healthy organization, most of the board members didn't understand the balance sheet. They continued to make decisions as if the organization was in trouble, even though the board treasurer - a banker who certainly understood the financials - repeatedly told them, "We are doing fine!"

***Some Balance Sheet Basics:***
The balance sheet is a snapshot of your organization's financial status TODAY, describing the relationship between what you own RIGHT NOW vs. what you owe RIGHT NOW.

The question answered by the balance sheet is simple: As of this very moment, how stable is our organization? If we were to put all the facets of our organization on one of those old-fashioned scales, would it tip over towards the side with the debts on it, or would it tip to the side of what we own?

Because the balance sheet is like that balancing scale, one individual number is of no importance without knowing how that number relates to the numbers on the other side of the scale. That relationship will show you how stable the organization is.

So is $50,000 in debt a lot or a little? If you understand the balance sheet, you will know that the answer depends on the rest of the story. With $20 million in the bank, $50,000 is probably not a lot of debt. With $27.32 in the bank, $50,000 is a lot of debt. On the balance sheet, no number stands alone - it's all about the relationships that tip your organization's scales in one direction or another.

**Profit and Loss / Income / Cash Flow Statement:**

- What story does the Profit and Loss Statement tell?
- Can you tell whether your organization's funding comes from many different sources, or just a few big contracts?
- Can you tell what your biggest expenses are? Is it ok that those are high? Why? Why not?
- When your board gets most riled up about a particular expense item, what percentage of the organization's overall expenses does that item represent?

***True Story:***
We witnessed a $1.7 million organization spend 15 minutes of a board meeting discussing the fact that the staff had purchased a $200 fax machine. Not only did they spend precious time talking about something that had already happened (without creating any policy to prevent the thing they were concerned about from happening again), but they spent that time on an item that amounted to *.01% of their annual expenditures.*

***Some Profit and Loss Statement Basics:***
The Profit and Loss Statement is like a summary of your checkbook, broken down by category. The P&L answers this question: What did we spend money on, and where did that money come from? One of the most important things to remember about this report is that it looks at the past.

There is little a board can do about the past, but you wouldn't know that from most board discussions of the Profit and Loss Statement! Because this report is so similar to their own finances, most board members feel comfortable picking apart the organization's expenditures, with no real end in mind. They just think that's what they are supposed to do!

There are, in fact, good reasons to examine the expense side of this report. One of those is to examine areas where proactive policies could prevent future problems.

But the area of real value for this report is one most boards ignore - the income side. Most boards miss the opportunity to examine, for example, whether the organization is receiving its funding from diverse sources, or whether all its eggs are coming from one basket - perhaps government funding or grants.

Without understanding the real significance to this "look into the past", boards spend inordinate amounts of time reviewing insignificant line item expenditures. Once this report is seen in context, however, it is easy to understand what really is worth discussing, and why.

**Budget:**

- What story does the budget tell?

- How often should you look at the budget throughout the year?
- Once the budget is approved, can it be changed throughout the year? Why? Why not?

***True Story:***
Every year, the XYZ Group would create a strategic plan. And every year, the plan wouldn't be implemented. When asked why nothing ever happened, the answer was, "There was no money in the budget to implement the plan."

***Some Budget Basics:***
The balance sheet describes today. The Profit and Loss statement describes the past. The budget, however, is all about the things the board can control - the FUTURE. The budget is nothing more than a projected Profit and Loss Statement. It tells what you anticipate spending money on, and where you anticipate funds will come from to pay for those expenditures.

The budget is evidence of the board's priorities. A budget that changes little from year to year is often proof of a board with few priorities for what the organization should be accomplishing in the community. A budget that shows marked change from year to year is often evidence of a board with aggressive priorities for making a real difference in the community.

- Will we increase programming in a particular area?
- Will we try to instil more stability into our income stream?
- How will we be aiming for better results for the community?
- Did we plan for implementing our strategic plan?

The budget should be able to answer those questions.

### Your Organization's "Bottom Line"

As you look at the things your board members should know about your organization's finances, and you consider the things they may NOT know, you can see that board members who don't understand the organization's financial matters make it difficult for the board to be accountable - both for the money, and for providing the mission.

And if the facts in this article haven't convinced you, maybe this will: Board members who do not understand the financial aspects of an organization are a huge liability - not just to the organization, but to themselves. Although most states limit the liability of individual board members, those waivers are based on the premise that board members have done everything they can to be prudent in their decision-making. Is there anyone who could argue that voting on a $2 million budget when you can't understand a balance sheet is prudent?

Suddenly, understanding the finances isn't a luxury. It's an imperative - not just for the good of the organization and the community, but for each individual board member.

So train your boards. Then test them. And make sure they are prepared to help your organization make significant improvement to the quality of life in your community.

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