Enhancing the Board's Role in Financial Management

In many organizations, the business of financial management is left to the staff with only cursory involvement from the board. To me, this is not only a huge organizational mistake, but also a dereliction of duty on the part of the board.

Most experts agree that the oversight of financial matters is a fundamental and critical responsibility of the board. And yet, in many cases, this responsibility is not carried out well. There are myriad reasons why this is the case. This article will not attempt to detail the shortcomings of boards. Rather, it offers some suggestions to boards and board members so they can be better prepared to carry out their responsibilities in the future.

Develop Financial Literacy

The first step in learning to be a player in your organization's financial management is to gain a basic literacy in finances. That means understanding the term of the trade, learning how to read financial statements, and understanding the unique accounting involved with nonprofits such as restricted funds and fund accounting – things that don't exist in the for profit world. Boards all too often leave this function to the staff CFO or maybe one person on the board who understands these things. However, I believe the whole board should have a level of competence sufficient for them to effectively engage in the dialogue of the organization's finances. I think it is the joint responsibility of the chief executive and the board chair to help arrange periodic training for the board as whole or at a minimum for the board members that serve on the Finance and Audit Committees. If you are a board member, and this training is not being provided, I would urge you to insist it be added to the board calendar. It is the only way you can begin to carry out your fiduciary responsibilities effectively.

Understand the Business Model

The second step is understanding how your particular organizational "machine" runs. Board members need to know where the revenue comes from and where it goes during the course of the fiscal year. In my experience and in the experience of colleagues I have talked to, most board members and even many executives do not have an appreciation for how the organizational "machine" really runs. One colleague related to me that in a recent seminar she asked members of the audience how their organizations earned their money. Mind you, these people were all from organizations that relied solely on philanthropy to fund their organization. Almost universally, the participants could not say what percentage of revenue came from grants, or what percentage came from direct mailing or what percentage came from events. In my own experience in an organization with widely diversified sources of revenue, virtually none of the board members could describe all the source of revenue and what percentage of income came from each. The lesson here is simple – if the board wants to steer the destiny and direction of the organization, the board members need to understand how the system works.

This is easy enough to achieve. The organization CFO or CEO should be asked to prepare a presentation for the board on revenue sources and expense categories. And this presentation should cover more than just a single year's experience. It should track several years of history to see how and if the revenues and expenses of the organization are changing and trending over time. If there is a Finance Committee on the board, that group should devote itself to becoming experts on the financial model and where the finances are headed.

Be involved in the Budget Process

The third critical step is to have board involvement in the budgeting process, and by this I mean true involvement and not just some sort of pro forma final approval when the real work of the budget process is done. I recommend an iterative process that involves the board Finance Committee as an active participant in the overall process.

1. The process should begin with the Finance Committee reviewing the actual results of the prior year. From there, the Committee along with staff executives should use their best estimating techniques to forecast the financial conditions for coming year. This information should be used to provide general financial guidance to the operational managers of the organization. This guidance should include direction on where financial belts need to be tightened or where additional resources will be required in the coming year.

2. Using the guidance from the board's Finance Committee, the operational managers prepare their detailed expectations of both revenue and expenses. These estimates should be based on solid operational analysis and not just "This is what we spent last year." When these operational budgets are completed, they are assembled by the staff finance department and returned to the Finance Committee.

3. The Finances Committee then reviews the assumptions used by the operating managers and examines the consolidated results for the organization. Assumptions should be challenged, estimates questioned and impacts considered. These discussions should also include some sense of activity prioritization for the full board to consider at the appropriate time. The committee should also look at alternative financial scenarios in order to understand what accommodations might be required if expectations are not met.

4. When the budget is acceptable to the Finance Committee, it should be brought forward to the full board. When this happens, care should be taken by the Finance Committee chair and the organization's financial staff to explain the key particulars to the full board including assumptions used, estimates made and priorities considered. These are all topics that should be reviewed by the board before a final decision is reached on the financial plan for the coming year. The alternative financial scenarios should also be discussed and a strategy agreed upon if assumptions prove to be incorrect. The final result is a detailed plan for how the organization will operate in the coming fiscal year.

Monitor Performance

Once the financial plan is prepared, the board cannot turn its back on financial managment. It must now become actively involved in periodically monitoring the progress of the financial year. To do this, revenue and expense plans need to be prepared to compare to actual results.

The most basic revenue/expense plan is a linear model. This model basically assumes that expenses/revenues will be earned or expended in a relatively constant manner over the course of the year (see Figure 1). This results in what can be termed "proportional" financial comparisions. For example, this model would say that at the end of the sixth month of the fiscal year, that half of the expenses should have been made and half the revenue should have been earned.

This type of monitoring tool may be sufficient for relatively simple businesses or organizations, but it will not fill the bill for any organization that is seasonally dependent (like most of us in the festival and event industry). In our organizations, a more complex tracking model is needed. More sophisticated revenue and expense plans need to be prepared. Figures 2 and 3 below show actual revenue and expense plans for a real organization in the festival and event industry. Note that while expenses follow a relatively constant output, revenue comes in spurts. To effectively monitor organizational financial performance during the year these "real world" plans need to be developed.

Preparing such plans can have an additional benefit. Superimposing the plans as shown in Figure 4 below will show how expected expenses occur *vis-a-vis* revenue. This can result in the identification of negative cash flow periods which must be recognized by the organization ahead of time and appropriately planned for.

So how are such plans prepared? The answer is to look to the past as a prologue for the future. It involves a five-step process.

1. First, lay out all actual revenues and expenses from the prior year on a month-by-month basis as shown here.

2. Next, convert the actual dollars to a percentage of the total revenues/expenses.

3. Repeat this process or the past three fiscal years.

4. Average the results for the previous three years as shown here.

5. Apply the percentage average to the total of the newly approved budget.

This process produces a realistic, experience-based forecast that can be used for monitoring purposes. (Note: The same process is followed for both revenue and expenses.) The actual monitoring process should involve comparing the revenue and/or expense plans to the actual experience of the current year. This should be a four-column analysis as shown below.

BUDGET	ACTUAL	VARIANCE	REMARKS
$16,148	$17,950	$1,802	Utility rates unexpectedly increased

This process can be used for the budget as a whole or it can be repeated on a program by program basis for more detailed monitoring. Comparisons should be made at least on a quarterly basis and even monthly during critical times in the year. This process of monitoring should continue throughout the year, and the board should watch for unexplained variances between budget and actual and inquire as to the reasons for such variances and recommended actions, if any are needed.

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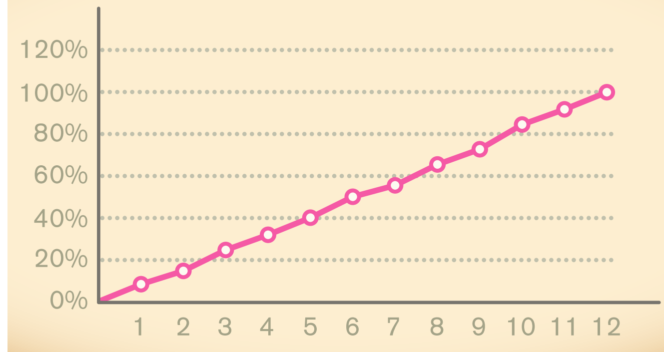
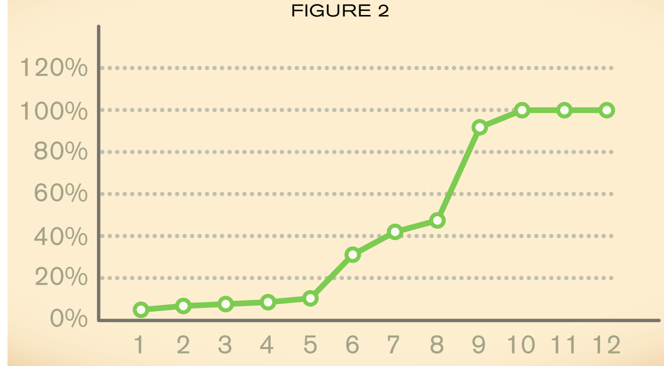
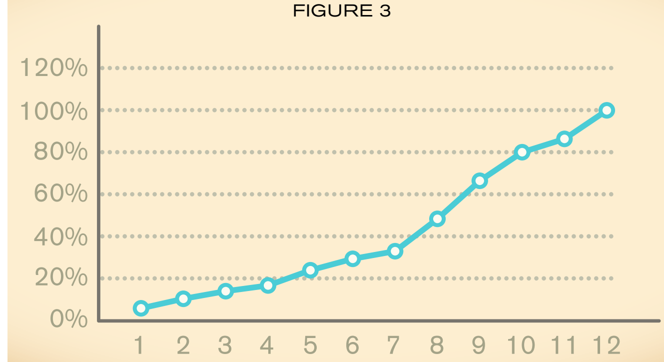
LINEAR TRACKING CHART
FIGURE 1



ACTUAL REVENUE
FIGURE 2



ACTUAL EXPENSES
FIGURE 3



REVENUE VS EXPENSES
FIGURE 4