A Board's Duty of Care in Financial Oversight: How to Avoid the Question: "Where Was the Board?"

Generally, the public hears about an organization's board and its members only when something goes wrong. At such times, the question is raised: "Where was the board?" When WorldCom disclosed its massive accounting fraud in 2002, Adam Feuerstein, in an article entitled: "WorldCom's Watchdogs Were Asleep," cites Charles Elson, director of the Center for Corporate Governance at the University of Delaware, who asked: "Were there red flags that they [the directors] missed?"[1] No board member wants to be asked such a question, combined with the accompanying accusation that *obviously,* major issues *were* missed, to the detriment of the organization and its constituencies.

However, beyond the potential public embarrassment of being perceived as an irresponsible board member, there are the spiritual responsibilities that accompany our governance service to various organizations, particularly educational institutions within the church. Ellen White reminds us that: "The accounts of every business, the details of every transaction, pass the scrutiny of unseen auditors, agents of Him who never compromises with injustice, never overlooks evil, never palliates wrong."[2]

Recognizing that our ultimate responsibility is to God, it is with humbleness that we must approach our work, particularly when acting in an oversight position where decisions can advance or hinder the mission of Seventh-day Adventist education. Again, from the pen of Ellen White:

"It is in humbly working by the side of Jesus that we find rest. Men who feel themselves sufficient to take upon themselves responsibilities that they cannot manage, do injury to themselves and to the cause of God. Yet they are so blind that they cannot discern but what they are fully competent to undertake any thing."[3] This article seeks to enhance board members' understanding of their responsibilities, both to avoid a blotch on their service and to overcome the blindness that may lead to overconfidence in the individual board member's personal knowledge and skills.

Being a member of an institution's board, whether for-profit or not-for-profit, carries significant responsibilities, including three important fiduciary duties: the *duty of care*; the *duty of loyalty*; and the *duty of obedience*.[4] Kay Sprinkel Grace describes this unique board member role in *The Ultimate Board Member's Book* by stating:

"On the one hand, you hold the organization in trust and are legally and financially responsible for its well-being. On the other hand, while it's not your job to manage daily op-

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erations, it is your responsibility to ensure that the person in charge manages all human and financial resources of the organization effectively, appropriately, and honestly."[5]

An understanding of financial information is required to monitor an institution's progress toward its stated goals and to assist in strategic planning so that it can accomplish its mission. Thus, it is essential that *every* board member possess a basic understanding of financial information, even if he or she is not specifically trained in accounting.

Fiduciary Duties

Let's define the three fiduciary duties that characterize the trust responsibilities of a board member. Specifically, the *duty of care* requires that he or she actively work with other board members to advance the institution's mission and goals. This requires attendance and participation in board meetings and service on board committees. It also requires that board members read and understand financial reports and ask questions as appropriate.

The *duty of loyalty* requires that the board member place the institution's interests ahead of his or her own interests. **Conflicts of interest*** (situations in which a person's personal interests or position in one organization conflict or compete with his or her relationship with or interests in another)[6] must be disclosed, and service to an institution as a member of its board must never become a means for one's own gain. The ability to maintain confidentiality is another critical aspect of a board member's *duty of loyalty*. This is especially important when it comes to discussing financial issues outside of the board room or during an investigation of dishonest or unethical behavior.

The *duty of obedience* places the responsibility on the board for ensuring the institution's compliance with applicable laws and regulations. It is the board's duty to ensure that the institution's mission is carried out in accordance with activities authorized by the school's legal documents, and in compliance with the legal environment in which it works.

As noted above, the *duty of care* requires that the board members read and understand financial reports and be both willing and able to ask questions when appropriate. Often when the agenda indicates that the financial reports will be the next item presented, board members take a break, either physically or mentally, by leaving the room or by checking their phones or tablets. It is insufficient for a member to rely on the board's finance or audit committees (or in small K-12 schools, the school administrator or treasurer) to meet his or her fiduciary responsibilities under *duty of care*.

Unpacking the Board Member's Duty of Care

To meet the *duty of care* obligation, board members must first understand the difference between the financial statements for a not-for-profit organization and a for-profit company. It is likely that the for-profit terms are more familiar to board members because they are the ones generally used in the literature. Different names are used for not-for-profit organizations' financial statements because these organizations do not have outside stockholders who expect a return on their investment. Instead, interested constituencies for the not-for-profit organization are concerned about the fulfillment of the organization's mission rather than a receipt of a monetary return or personal benefit from their contributions to the organization (in this article, that would be the educational institution).

The names of the basic financial statements follow in Table 1. Note the difference in the name of the residual (what remains) after the liabilities are subtracted from the assets. For-profit organizations have owners, stakeholders, and investors, for whom "Owners' Equity" indicates the proportion of the assets that are not held by the creditors, and thus are held by the owners. Since not-for-profit organizations do not have owners, "Net Assets" serves as an indicator of the proportion of the assets that are not held by the creditors but are under the control of either the donors (because they are restricted for a specific purpose) or are available for governance distribution.

Table 1. Names of Basic Financial Statements.

Not-for-Profit Organizations	For-Profit Organizations
Statement of Financial Position	Balance Sheet
Statement of Activities	Income Statement
Statement of Cash Flows	Statement of Cash Flows
Assets – Liabilities = Net Assets	Assets – Liabilities = Owners' Equity

In addition to receiving the above financial statements, board members should also ask administration to provide them with the following:

1. Cash-flow forecasts;
2. Actual operating results compared to budget;
3. Operational ratios (e.g., **Accounts Receivable Turnover*** or **Days Cash on Hand***);
4. Trend analyses; and
5. Information about the external environment that is of importance to the organization(educational institution).

Capital projects or new programs that are under consideration by the board may require specialized budgets of their own rather than being included in the annual operating budget.

Specific Financial Responsibilities

The fiscal responsibilities of the board may be categorized under three headings: financial planning, financial controls, and financial reporting.[7]

1. Financial Planning

The operating budget is the institution's stated plan, ex-

Box 1. Definition of Terms.*

AAA

The Accrediting Association of Seventh-day Adventist Schools, Colleges, and Universities (AAA) is the denominational accrediting authority for all tertiary and graduate educational programs and institutions owned by Seventh-day Adventist Church entities, and reviews and endorses accreditation of secondary schools upon the recommendation of the Commissions on Accreditation of each division.

Conflicts of Interest

Situations in which a person's personal interests or position in one organization conflict or compete with his or her relationship with or interests in another. This includes seeking personal benefits or privileges for self, family, business partners, or others based on one's official capacity; accepting gifts or financial compensation based on inside knowledge gained from one's position; benefiting from information shared as a result of being a member of a board; and putting one's personal interests above those of the institution served.

Current Ratio

The relationship between current assets and current liabilities; used to measure an organization's liquidity or ability to pay its creditors. Computed by dividing Current Assets by Current Liabilities. Both figures are available on the Statement of Financial Position. Ideally, the Current Ratio should be 2:1.

Operational Ratio: Accounts Receivable Turnover

How to Compute: Divide net income from tuition by the average accounts receivable for the year. This measures the number of times a year the Accounts Receivable is collected. One can obtain the average collection period by dividing 365 by the Accounts Receivable Turnover. For example, if the Accounts Receivable turnover is 10, the average collection period is 36.5 days (365/10).

Operational Ratio: Days Cash on Hand

How to Compute: Divide total annual operating expenses (excluding depreciation) by 365 to obtain daily operating expenses. Then divide "cash and cash equivalents" by the daily operating expenses to arrive at the days' cash on hand. This is a good measure of sufficient cash.

Quick Ratio

The relationship of an organization's quick assets (cash, accounts receivables, or investments that can be quickly converted to cash—typically within 90 days) to its Current Liabilities. Ideally, the Quick Ratio should be 1:1.

Restricted Assets

Cash or assets, the use of which is restricted by the donor for a specific purpose.

Restricted Net Assets

Cash or assets designated by the donor for a specific purpose.

Unrestricted Net Assets

Cash or assets held by a not-for-profit organization without restrictions on how they can be used.

pressed in financial terms. The board must receive and approve the operating budget of the school on an annual basis. Following approval of the document, the board should monitor the budget on a monthly basis. The purpose of approving and monitoring the budget is to ensure that allocations have been used as voted, and that the income received and the assets of the institution are used to further institutional mission.

When approving the budget, board members should look first to the bottom line to see the expected result of operations. Does the annual financial plan indicate the expectation of a gain or a loss for the period? If the board is being asked to vote a budget that shows a loss, the members should request administration to explain the anticipated loss and to clarify when the institution can be expected to return to profitability. When monitoring the budget, board members should check to see if the year-to-date budget and the actual figures are showing a net result close to the budget. If so, they can have some confidence that there have been no negative changes in the operations of the institution and that the original plan is in effect. If there is a variance, the board should ask why and what is being done to correct the situation.

If the board does not meet on a monthly basis, the members should ask the institutions' financial administrator what processes are in place for both reviewing the internal financial statement in the off-months and for reporting on deviations from expected results. In addition, board members will wish to monitor the cash flow to be certain that the institution does not become insolvent.

2. Financial Controls

The board is responsible for ensuring that a strong internal control system exists (and if not, seeing that one is created). This will ensure that the assets, particularly the cash, can be accounted for and are not misused. Board members should ask questions about how the school's internal control system is designed and maintained.

External audits should be conducted annually (see *Working Policy* S 29 05).[8] If the external auditors indicate that the institution has weaknesses in its internal control system, the board should require the administration to address those weaknesses and submit a report regarding the adjustments made in response to the auditors' recommendations. If the board has an audit committee, it may choose to delegate some of this responsibility to this group, with the understanding that they will report back to the entire board regarding the efficiency of the institution's internal control system.

One important control that the board should monitor is the monthly comparison between actual operations and the budget. The administrators (the president or principal of the institution or the financial administrator) should be required to show the Statement of Activities in a comparative format so the board members can readily compare actual operations with budget-to-date figures. Variances should be identified for the board and explained by the school's administrators.

3. Financial Reporting

At every official meeting, board members should receive and review the financial information for the institution in order to evaluate its financial health. Therefore, every new board member should be trained by the Chief Financial Officer (CFO) or similar staff person (or in the case of small schools, the treasurer of the conference or school) on how to read and use financial reports and how to identify the institution's critical financial factors. Veteran board members should periodically be required to attend a refresher training course.

In addition to understanding the school's financial statements, secondary and tertiary boards are responsible for ensuring that the administration prepares and files all required **Accrediting Association of Seventh-day Adventist Schools, Colleges, and Universities (AAA)*** documents**.** All boards must ensure that government reports are submitted on time. In some cases, the board may delegate the actual review of such governance reports to its finance committee, which then ascertains and reports whether the filings were completed on time.

Erin Welch's article, "Speed-reading Non-Profit Financial Statements,"[9] will be helpful in assisting board members who feel uncomfortable trying to interpret columns of numbers on financial statements and are unsure which numbers are in fact the most important. She recommends the following tips for understanding the Statement of Financial Position and the Statement of Activities":

For Reviewing the Statement of Financial Position:

1. Review the liquidity ratios, specifically the **Current Ratio*** and the **Quick Ratio*** Board members may ask the administration to provide these ratios to them on a regular basis.

2. Examine the year-to-year financial trends. Ask: Is the current ratio increasing or decreasing? Is there growth in **Restricted Assets***?

3. Note the direction of the institution's debt. Rapid growth in debt may foretell an impending crisis.

4. Ask how the proportion of the institution's **Unrestricted Net Assets*** compares to its **Restricted Net Assets**.* Does the institution have sufficient liquidity (i.e., unrestricted net assets) to remain solvent? Board members should also ensure that restricted funds are properly accounted for and that restricted cash is separated from cash available for operations. The school may appear to have a lot of cash, but if the majority of the funds are restricted for specific projects, it can have a cashflow problem. If indeed a cashflow issue exists, board members should ask whether the organization has access to credit.

For Reviewing the Statement of Activities:

1. The board should review the amount budgeted versus actual amount spent, looking for significant variances. Board members should understand the cause and effect of any significant variances and inquire about the administration's plans for addressing them. In particular, they should inquire which of the major expenses are rising more rapidly than income.

2. School administrators should alert the board members to concentrations of revenue and identify whether the organization relies heavily on one income source (e.g., tuition income or subsidies). If so, board members should ask the

Box 2. Additional Resources.

***A Guide to Financial Statements for Not-for-Profit Organizations: Questions for Directors to Ask*.** CPA Chartered Professional Accountants, Canada. Originally published by the Canadian Institute of Chartered Accountants, 2012: https://www.cpastore.ca/product/a-guide-to-financial-statements-of-not-for-profit-organizations-questions-for-directors-to-ask/1425.

Buck, Peter A. **"Tips for Communicating Financial Information to the Board"**: https://www.ksmcpa.com/tips-for-communicating-financial-information-to-the-board.

CIMA Performance Reporting to Boards: A Guide to Good Practice: https://www.cimaglobal.com/Documents/ImportedDocuments/perf_reporting.pdf.

"Directors' Responsibilities for Financial Reporting: What You Need to Know," ACCA Chartered Accountants. Australia and New Zealand (2017): https://www.accaglobal.com/content/dam/ACCA_Global/professional-insights/Directors-responsibilities-for-financial-reporting/pi-Directors-Guide-to-Financial-Reporting.pdf.

Dave C. Lawrence, **"Communicating Financial Matters: Expectations of the School Business Officer,"** *The Journal of Adventist Education* 70:5 (Summer 2008): 37-42: http://circle.adventist.org/files/jae/en/jae200870053706.pdf.

__________, **"A Board Member's Guide to Financial Statements,"** *The Journal of Adventist Education* 66:5 (Summer 2004): 24-28: http://circle.adventist.org/files/jae/en/jae200466052405.pdf.

Milton, Leslie. **"Why Board Members Need to Understand Financial Statements"** (November 3, 2017): https://www.ggfl.ca/financial-statements-board-members.

president or principal to share his or her contingency plans in case there is an unexpected drop in income (e.g., due to a sudden decrease in enrollment or subsidy reductions). Since the board is responsible for the long-term viability of the institution, members may wish to consider how to diversify income in order to build the school's financial strength.

A Privilege and a Responsibility

Being asked to serve on the board of an educational institution is a privilege and a responsibility. The pleasure of seeing a school thrive is immeasurable, and knowing one played a small part in its success brings rich rewards. However, when people agree to serve on a board, they also assume responsibility for the institution's finances as part of fulfilling their fiduciary responsibility for *duty of care*. The board has a responsibility to ensure that policies are in place to not only prevent the abuse and misuse of financial resources, but also to address such irregularities when they occur. As Leslie Milton put it so succinctly: "There is no place on a board for members who are willing to leave that 'money stuff' to others."[10] ✐

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