Balancing the Mission Checkbook

**Why board members miss the red flags**

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Nonprofits Assistance Fund is sometimes called in to help nonprofits when they have financial problems that have been building for a long time. Fortunately, financial turnarounds are possible and we’ve seen some incredible work at nonprofits that resulted in financial recovery. Whether the outcome is positive or negative, though, in every case the situation would have been more manageable if it had been identified and addressed sooner. At some point, the question comes up: why didn’t someone, including board members, see the red flags and call attention to them sooner?

There are hundreds of reasons, of course, including disengaged boards, weak fiscal controls, misunderstanding of roles and responsibilities, and lack of timely information. I’ll offer one technical reason: boards miss the red flags because they don’t know where to find them.

*But red flags should be obvious on the financial reports, right?* Not really.

Some background: there are two standard financial reports that should be provided to the board of directors regularly, the income statement and balance sheet. From all the training workshops we’ve delivered over the years we know that the income statement makes sense to most people, especially when the report includes a comparison to the budget for the same period. With some basic training board members can get comfortable reviewing how much income is coming in, what the expenses have been, and where the actual performance varies from budget. Balance sheets, on the other hand, are not easy to read or interpret. They are based on accounting terminology and standards that require more training and experience to make them useful. Nonprofit accounting rules for restricted funds make balance sheets complex even for experienced finance professionals from the business sector. It’s hard for board members to get a handle on what’s important on the balance sheet or feel comfortable asking questions.

*So, why do board members miss the financial red flags?*

**Boards pay too much attention to income statements and budgets.**  
The periodic income statement is useful for tracking progress and expense controls, but this report is very limited because it is covers such a short time period. Big variances are useful to alert boards to questions. Deficits are cautionary signs that deserve analysis. A surplus or a deficit in one month, or even one year, is usually not the sign boards need. What matters is the cumulative financial condition over time, signs that indicate a big problem that threatens a nonprofit’s future.

**Boards don’t pay enough attention to balance sheets.**  
Many (most?) board members pass over the balance sheet or skim it, at best. That’s too bad, because the balance sheet is the key for seeing the problems. The balance sheet reports the cumulative effect of all of a nonprofit’s financial activity over the years and signals financial health or problems. Healthy nonprofits build up assets, cash reserves, and unrestricted net assets, and maintain reasonable amounts of debt. Nonprofits with serious financial problems report diminishing cash, insufficient working capital, restricted funds diverted to current operations, negative unrestricted net assets, and creeping debt levels. *Those are the red flags that should make board members jump up and down and shout – look over here.*

***Yellow flags are on the income statement. Slow down, look both ways. Red flags are on the balance sheet. Stop – now!***