

How Board Members Can Learn to Spot Red Flags

by Kate Barr

Two reasons why boards can miss the red flags that pop up along the way to an organization's financial collapse are the complexity of business models and the tendency of boards to separate the roles of governance and management. The solution, says the author, is for board members to get in the habit of asking good questions and grabbing the reins in the event that a board collectively skirts a problem and fails to act.

Editors' note: This article is adapted from the *Nonprofits Assistance Fund* blog, *Balancing the Mission Checkbook*, January 7, 2015, and was published on NPQ's website on January 8, 2015.

HERE WE GO AGAIN. A FEW WEEKS ago, the *Nonprofit Quarterly* reported on the fallout from reports by FEGS Health & Human Services in New York of an unexpected \$19.4 million loss: changes in the executive office and cuts to programs and budgets.¹ Like many others in the sector, one of my first reactions was to ask, Where was the board?

This question comes up all too often. People's Health Clinics in Baltimore closed in June 2014 with almost \$500,000 owed to the IRS for payroll taxes, a cancelled federal grant, and unpaid rent and other bills. Locally, we've been following Community Action of Minneapolis-based education services provider TIES's critical audit report and financial challenges. Did the boards of these organizations miss such red flags as diminishing cash, ballooning debts, and recurring deficits? Each of these news stories includes documentation, audit reports, and other evidence of problems. If we can read about the information now, why didn't the members of the board see and address the problems?

Maybe the boards *did* miss the red flags. Human beings possess the gift of hindsight; at the time, the signs may have been obscured for a variety of reasons. One reason is the role of governance versus management. As reported in the *Star Tribune*, the chair of the TIES board's executive committee said that "directors were not aware of the problems that the audit revealed because they aren't involved in day-to-day operations."² That is absolutely true and is one of the quandaries of board members as fiduciaries. After all, how would a board member know that a report was filed correctly or if a contract payment was adequate? Most board "best practices" warn about micromanaging. Boards rely on the executive and staff to manage the organization and to be forthcoming and transparent with information, including information about problems.

Another factor is the complexity of nonprofit business models. FEGS Health & Human Services is a multiservice agency with a \$250 million budget and multiple nonprofit and for-profit subsidiaries. This is a big, complicated business entity with equally complicated

financial reports. While most nonprofits are much smaller, many operate a variety of programs with different types of revenue, cost structure, cash flow, and capital. Business models are complex. If I'm a board member, which of the financial reports do I need to study and scrutinize? This is a serious challenge for all board members, especially those who don't feel confident in their finance knowledge and skills.

So, what can board members do? Learn how to ask good questions!

One advantage that board members have is time and a broad scope. Serving on a nonprofit board is a cumulative activity carried out over a three- to ten-year period. Auditors, funders, and watchdogs generally suffer from tunnel vision—information is reviewed for a short time period, a single program, or a limited aspect of the organization. Board members, on the other hand, review financial reports, program results, and strategic goals many times over, and have the opportunity to continually gain more knowledge and understanding. They learn about what's important or typical

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or unusual. This is crucial, as all of the problems reported in the above stories built up over time.

Rather than expecting board members to instantly recognize a problem in the making, let's encourage boards to learn to ask the questions that will lead them there. One month with a deficit isn't a red flag, but questions must be asked when a board sees financial reports with unfavorable variances and deficits in meeting after meeting. The same goes for other financial indicators, such as cash-flow dips or bumps-up in liabilities. I know board members who are concerned about asking a “dumb question”; my advice to them is, Okay, don't ask it the first time the question comes up—but please ask it by the third time you have the same question.

Practice asking questions like these:

- “Can you help me understand what this means?”
- “Is this a trend or pattern that we should talk about?”
- “Is this unexpected?”

You can be certain that you won't be the only member of the board who wants to know the answer. *Remember: Board members have the benefit of time and cumulative understanding.* Take advantage of that, and ask some questions.

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This article is essentially part 3 of two earlier pieces. In “Why board members miss the red flags,” I suggested that one reason is the way in which board members use financial statements.³ In that piece, I proposed that boards pay too much attention to income statements and budgets—short-term information—and not enough attention to the long-term perspective of balance sheets. (Yellow flags are on the income statement; red flags are on the balance sheet.)

In the follow-up piece, “Why board members miss the red flags, part 2,”

I acknowledged that boards of nonprofits with critical financial problems sometimes look the other way—usually because of a combination of embarrassment and fear of tarnished reputations and reluctance to take on the huge task of dealing with the problems.⁴ While some individual members may raise the right questions, collectively the board skirts the problems and fails to act. If you are a member of the board of a nonprofit with red flags flying, it may be up to you to grab the reins until attention is paid.

It's not fun, but nothing less will do.

KATE BARR is executive director of the Nonprofits Assistance Fund.

NOTES

1. Martin Levine, “Surprise! 19.5 Million Surprise Loss Rocks an Important NYC Social Service Agency,” December 19, 2014, *Nonprofit Quarterly*, nonprofitquarterly.org/management/25353-surprise-19-5-million-surprise-loss-rocks-an-important-nyc-social-service-agency.html.

2. Jennifer Bjorhus, “Audit finds St. Paul-based nonprofit funded by state schools misspent millions,” *Star Tribune*, updated December 4, 2014, www.startribune.com/local/stpaul/284833901.html.

3. Nonprofits Assistance Fund; *Balancing the Mission Checkbook*; “Why board members miss the red flags,” blog entry by Kate Barr, February 16, 2012, nonprofitsassistancefund.org/blog/2012/02/why-board-members-miss-red-flags.

4. Nonprofits Assistance Fund; *Balancing the Mission Checkbook*; “Why board members miss the red flags, part 2,” blog entry by Kate Barr, May 23, 2012, nonprofitsassistancefund.org/blog/2012/05/hy-board-members-miss-red-flags-part-2.

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