Financial Malfeasance and Nonfeasance: Ten Pitfalls Boards Should Avoid

By Jon Pratt, executive director of the Minnesota Council of Nonprofits. Reprinted with permission of Board Member, a publication of BoardSource.

Recitals of fiduciary duties of boards are rich in prescriptive advice about due diligence and prudent investments, but usually fail to explain just how things can go wrong. Learning from the bad experiences of others is strongly preferred to the school of hard knocks, especially since board members may confront any given situation only once or twice in the course of serving on many boards.

The following are my nominations for the top ten types of financial malfeasance (misconduct or wrongdoing) and nonfeasance (failure to perform an official duty) by nonprofit boards.

1. **Ineffectually scrutinizing the overall enterprise.** Proper financial oversight requires board members to receive (and read) timely financial statements. An obvious red flag is late or incomplete financial reports, but statements that are either too voluminous or too sketchy can be just as bad. Three frequent blunders of boards are: they don't receive or distribute to other members the organization's IRS Form 990, the informational disclosure from that most nonprofits must file with the IRS every year; they don't know how functional allocations were made (between fundraising, management, and program expenditures); and they don't discuss their auditor's management letter.

2. **Failing to monitor key indicators, allowing the organization to drift into financial trouble.** Both the management and the board need to make sure revenue and expenses match up -- tracking trends in income, debt-to asset ratios, and overspending in particular budget categories. When income is delayed or less than expected, a surprising number of executives are reluctant to tell the board. Instead, they hope things will turn around; meanwhile they defer paying outside obligations, including the IRS. If you are a board member there is nothing more frustrating than to discover your personal tax refund has been frozen pending satisfaction of an IRS claim against the charity you serve.

3. **Failing to pay sufficient attention to whether the organization's financial resources are being effectively spent on programs.** What are the documented performance results of the major programs of the organization? Donors, the media, and recipients of services are all asking for documentation of outcomes, not just the number of clients served or total dollars spent.

4. **Being too trusting of staff who handle money.** While the people in the office with the blank checks would not have been hired if they were not judged to be trustworthy, prudence requires that boards not only trust but verify. The embarrassing number of embezzlement cases in nonprofits is due to inadequate internal controls (separation of functions, limits on check writing authority, etc.), and some boards are now forming financial control committees.
5. **Lacking strong external checks on financial reporting.** Organizations with budgets above $750,000 per year should have a certified audit, but many do not (only three states require registered charities to have an audit).

6. **Emphasizing executive compensation at the expense of other employees.** Board members are frequently grateful for the hard work of senior management and show it by paying competitive salaries. The focus on executive pay to the neglect of organization-wide compensation policy results in steeper hierarchies of pay, with stagnant income from the middle of the organization down, decreased morale, and high turnover among front-line workers.

7. **Failing to “bid out” the sale of organizational assets.** The most pressing examples of uncompetitive sales are in the current wave of nonprofit hospital conversions, but the same issues have risen in sales of buildings, camps and religious television stations, which often go to a single bidder. Has the board independently ascertained the selling price to ensure its fairness?

8. **Failing to scrutinize outside service contracts sufficiently.** Is the organization getting the best deal possible from its fundraising, direct mail, or telemarketing consultants? Most outside contracts should be re-bid at least once every three years.

9. **Spending funds restricted by time or purpose.** Sometimes board reviewing financial statements allow special project dollars, capital, and even endowment funds to be spent on general expenses as a “temporary” internal fix for cash flow problems. Such temporary uses of restricted funds are technically a violation of law in every state, but the real problem is that many organizations dig themselves into permanent holes.

10. **Mixing charitable and business interests.** Board conflicts of interest are on the rise as nonprofits increasingly seek out “win-win” partnerships. The dilemma is that this is an intentionally tangled web. Since many board members are sought for their connections, it is not surprising that some board members leverage deals at both ends of the relationship. Staying on top of organizational finances is more and more important, especially in light of increased use of the Internet as an accountability tool for the nonprofit sector. Most organizations' IRS Form 990 is available on the Internet, allowing the whole world to look over and organization's shoulder and second-guess any financial decision of the board.