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**ENHANCING NONPROFIT GOVERNANCE
THROUGH BETTER INFORMATION FLOW TO DIRECTORS**

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**ENHANCING NONPROFIT GOVERNANCE
THROUGH BETTER INFORMATION FLOW TO DIRECTORS
(Draft as of August 2012)**

ABSTRACT

To counteract the ability of a nonprofit's chief executive officer to control information reaching the board of directors, we recommend that a nonprofit board consider requiring leaders of the organization's various functions to provide operational reports directly to the board on at least an annual basis. Additionally, we recommend that a board discuss these reports directly with management members, preferably without the participation of the CEO. Implementing such a protocol should strengthen the board's ability to make decisions based on information from sources in addition to that of the CEO, improve the directors' ability to independently evaluate members of the management team, and increase the directors' understanding of the nonprofit's activities and performance.

Keywords

Nonprofits; directors; governance; accountability.

INTRODUCTION

Nonprofit boards tend to suffer from various corporate governance problems that have led some observers to propose that: "Effective governance by the board of a nonprofit organization is a rare and unnatural act" (Taylor et al 1996, p. 36). The difficulties of achieving effective governance for nonprofits arise from the interaction of several factors. Directors may be appointed for reasons other than their governance expertise or business experience *per se* (the nonprofit itself may really want the directors it appoints for fund raising, their contacts, or to enhance the reputation of the nonprofit, Bowen 1994).

Because most nonprofit directors are volunteers, the links normally found in the corporate sector between director accountability and compensation are nonexistent. When they are serving as unpaid volunteers, nonprofit directors generally face little personal risk for their decisions (Bishop 2008). Accordingly, individual nonprofit directors may simply disengage from nonprofit boards, particularly when they are denied adequate strategic information about the organization or that are relegated to nonstrategic operational issues by the nonprofit's executive officer (Chait and Taylor 1989). Such a mindset is reinforced by "[t]he fact that individual trustees are rarely identified with troubled nonprofits, even in highly publicized situations ..." (Bowen 1994, p. 41).

In addition to the traditional challenges of bringing a strategy into focus, establishing organization policy, selecting leadership, and dealing with operational results and finances, nonprofit boards face the challenge of integrating nonprofit directors from varied business and non-business backgrounds into a cohesive team that understands and is focused on the mission of the nonprofit (Bowen 1994). Nonprofit boards, which tend to be large, need to avoid the temptation to rely on a small executive committee to assume the powers of the entire board to make decisions, with the entire board serving only as a "forum for reporting the executive committee's decisions." (McFarlan 1999, p. 8). Failure to do so is an abdication of the directors' oversight responsibility as this responsibility requires each director to use his judgment to make informed decisions.

Members of nonprofit boards need to understand the essential differences between nonprofit and for-profit organizations. In particular, nonprofit directors need to appreciate the fundamental importance of the nonfinancial mission and evaluation of the nonprofit's programs to meet that mission, the nature of raising funds for nonprofits, and often, the challenges faced by large boards trying to make long-term decisions (Epstein and McFarlan 2011). Nonprofit directors from the business world may fail to appreciate that non-financial results are more important than the financial results of a nonprofit. As McFarlan observes, "The financial tail must not be allowed to wag the nonprofit dog. Board members from the for-profit world often have great trouble with this concept because it goes against all their training" (1999, p. 5).

Nonprofit boards must also avoid the pitfall of being "a collection of high-powered people involved in low-level activities" (Taylor et al, p. 36). Nonprofit directors may need

to overcome a perception by the organization's staff that volunteer directors lack sufficient expertise to understand or lead the nonprofit organization (Bowen 1994). Further, nonprofit directors who come from the business world may need to overcome a nonprofit staff's resentment of or hostility toward professionals from the for-profit arena. That resentment could lead nonprofit staff to skew information or withhold information from the directors (Bowen 1994). Such distortions in information flow to directors can seriously impede a board's ability to make informed decisions for the organization.

Finally, but by no means of least importance, nonprofit boards are facing increased pressure to be accountable to donors, clients, government agencies, and the public for the use of funds and operating performance (Green and Griesinger 1996, p. 396; Morrison and Salipante 2007). If they are to be accountable, nonprofit boards must meet the challenge of effectively training new board members, setting specific duties for committees and board members, and evaluating the board's oversight performance (Green and Griesinger 1996, p. 396). All these require directors to have in-depth information about the nonprofit's activities.

Directors of nonprofits, even if diligent and part of a cohesive, focused board, tend not to be provided with the same depth of information as is provided to directors of for-profit corporations. As Green and Greisinger observe, "Even in those organizations where boards professed high levels of legal and fiduciary accountability, there appeared to be tremendous reliance on the CEOs" (1996, p. 398). The difficulties in establishing effective nonprofit boards and the dangers in relying too heavily on the nonprofit CEO are exacerbated by the ability of the CEO to control the flow of information to directors. This can lead to board decisions that do not rest upon a solid foundation of information.

In the discussion that follows, we examine how boards can be more effective and how the influence of nonprofit CEOs can be counterbalanced by various means that improve information flow to nonprofit directors, enabling them to be more effective. We also recommend that both executives and directors of nonprofits be required to certify that they have performed their respective duties on behalf of the organization.

COUNTERBALANCING THE CONTROL OF INFORMATION BY CHIEF EXECUTIVES

If nonprofit directors are to make informed strategic and policy decisions and effectively perform their oversight function of the nonprofit's operations, they need to receive (in a timely manner) all the material information relevant to issues that are under consideration. However, directors are dependent upon nonprofit management for this information. The transparency of informational flow from nonprofit management to the board in turn depends on the attitude, perception, and forcefulness of chief executives who control that information flow (Ramirez 2007). The power that chief executives have to control information flow stems from their control of the top management team ("TMT") itself, as well as a CEO's ability to influence a volunteer chairman as to the timing, agenda, and focus of board meetings. While the typical nonprofit has a volunteer chairman of the board (McFarlan 1999), a nonprofit CEO's ability to control is further enhanced in those situations where the CEO also serves as the chairman of the board. A chairman who is also CEO has added ability to heavily influence or control the board's agenda and topics of discussion; meeting mechanics, timing, meeting duration; and the selection of directors. Moreover, the CEO can influence directors who are also members of the TMT. This CEO power to control is enhanced in the nonprofit arena because, compared to the corporate sector, directors of nonprofit organizations can tend to depend more heavily on nonprofit CEOs for guidance and leadership (Bowen 1994).

Given the opportunities that a chief executive has to control (intentionally or unintentionally) the quality and quantity of information that directors receive, the board itself must be careful to ensure that the nonprofit has established procedures to make sure that directors receive, in a timely manner, the material information they need to make informed decisions. In particular, nonprofit directors should ensure that management has put in place mechanisms for gathering and conveying timely, accurate, and complete information. In the first instance, such information should be provided to management itself through established organizational processes, but key information should then be provided to nonprofit directors through management. The guidelines in the America Bar Association's Corporate Director Guidebook (2007, pp. 19-20), although targeted at for-profit corporations, can also be usefully applied to nonprofits:

“[directors should] require management to provide them with information that is: (i) timely and relevant, (ii) concise and accurate, (iii) well organized, (iv) supported by any background or historical data necessary to place the information in context, and (v) designed to inform directors of material aspects of the corporation's business, performance, and prospects.”

For information to be useful to nonprofit directors, it needs to be provided in a timely manner in advance of meetings, so as to provide directors with sufficient time to study the materials and to develop meaningful questions that can be then be discussed among themselves, and with management, at board meetings. Management should expect that directors will inevitably have questions based on the materials they are provided. To this end, meeting agendas should explicitly allow time at board meetings for directors to explore issues with management.

The meeting agenda for nonprofits should be set by the board itself, not by management or the nonprofit's chief executive. Nonprofit directors should also ensure that agendas for board meetings include appropriate topics and sufficient time to educate themselves about the material aspects of the nonprofit's operations, strategic issues, and performance metrics.

REQUIRING ANNUAL TOP MANAGEMENT TEAM (TMT) REPORTS

Potential problems with information flow from the TMT in general (and the chief executive in particular) include nonprofit directors being provided with selective or biased information, or directors not being provided with the required information at all. To avoid such problems, directors should require that each member of the TMT (and any other manager responsible for a significant aspect of the nonprofits operations), provide (at least on an annual basis) a report to the board regarding their respective areas of responsibility. The TMT member report should include a statement that the TMT member has provided the board with timely, adequate, and complete information regarding the TMT member's area of responsibility during the year. In addition to an annual report from each TMT

member, the board should require TMT reports whenever a significant initiative is being contemplated, such as an alliance with another agency; developing a major, new source of funding; or a substantial changes in the service levels (or in the nature of services) being provided by the nonprofit.

The logical timing for the submission of TMT reports to nonprofit boards is when the board considers the nonprofit's required annual 990 filing with the Internal Revenue Service. Alternatively, the board could choose to require TMT reports at regular intervals during the year. However, requiring more frequent TMT reports could diminish the significance of the reports for the TMT and directors alike, as well as requiring an inordinate amount of management time to prepare reports more frequently than annually.

To increase TMT accountability to nonprofit boards, each TMT report should be signed by the responsible manager and include a certification along the lines that:

“To the best of my knowledge, the information in this report is current, accurate, and complete with respect to the matters and activities it addresses. In preparing this report, I have taken all reasonable steps to develop and communicate to directors in this report all of the material information associated with the services I am responsible for managing, including the results of services or other operations and pertinent information regarding financial condition and strategic risks and opportunities. Further, I certify that the organization's controls and procedures are adequate to reasonably ensure that I have received all relevant material information from the organization necessary to make this report and certification and that I will update or correct this report in the event I receive information in the future that has a material effect on this report.”

The TMT report should include a description of the organization's process for developing, reviewing, and communicating information from the operations of the nonprofit to the TMT member. This information should be consistent with the documentation given to the nonprofit's auditors each year as part of the audit process. And the TMT reports to the board should have sufficient focus and depth with respect to the issues covered to fully inform directors of all the facts they need to evaluate performance for the year. The report

should also include a description of the TMT member's plans to address current and prospective challenges facing that area of the nonprofit's activities.

Also, TMT reports should be reviewed by the nonprofit's external auditors as part of any regular audit process. The TMT and the auditors should review the TMT reports before they are submitted to the board in order to discuss and resolve any inconsistencies they may have with respect to the description of the activities and results in the TMT reports. The board would then review the submitted reports with the TMT members as part of the annual review of the 990 filings (we discuss this issue in more detail later).

LOGIC FOR REQUIRING TMT REPORTS

TMT reports would serve five main objectives. First, TMT reports would give directors better information to use as a basis for discussing annual performance of the nonprofit and its management with the TMT. Second, it would provide directors with a basis for discussing the adequacy of information systems used by the TMT to develop and evaluate information that is being presented to the board. Third, in the absence of any facts to the contrary, directors would generally be protected under the law for assuming the timeliness, accuracy, and completeness of information they receive from TMT members and use as the basis for making decisions. (This is much more likely an issue for any directors that are compensated rather than volunteers). Fourth, requiring reports and certifications from each member of the TMT should encourage nonprofit managers to carefully review the information that they provide to directors throughout the year for accuracy and completeness, help create more transparency, and avoid errors or omissions in disclosures that might adversely affect board decisions. The reports would enhance the likelihood that directors have the opportunity to address the material issues the nonprofit is facing and lessen the possibility that the CEO or TMT could fail to apprise the board of a significant issue.

Finally, and perhaps most significantly, requiring reports from both the CEO and other TMT members could usefully counterbalance the control of information that a nonprofit CEO often has. Creating the expectation for direct interaction between the board

and the TMT as a whole regarding substantive matters will counteract the tendency of some CEOs to shape the content, characterization or expression of information relayed to the board by the TMT “either as a matter of management style or due to deep-seated doubts about the board’s ability to make sound decisions” (Chait and Taylor 1989, p. 54). An open and thorough approach to transmitting information from management to the nonprofit board would also have the effect of better educating volunteer directors as well as leading to more informed decisions by those directors.

SUGGESTED CONTENTS OF TMT REPORTS

While the nature of each TMT report would inevitably be influenced by the specific operations for which each nonprofit manager has responsibility, the board should establish some general expectations for such reports. For example, the board should consider requiring that the chief executive and each other member of the TMT address the following questions:

1. How does the organization develop timely, accurate and complete information for the board and how adequate are the systems controls and review processes?
2. How have the strategic initiatives of the organization been advanced during the year?
3. How satisfied are the nonprofit’s donors and funders with the strategic direction and services provided to clients.
4. How satisfied are the clients with the services and what benchmarking information have you developed to assess the effectiveness of the services and operations?
5. What is the current condition of each the following?
 - a. existing fund sources (Is there a dependence upon one or a few sources of funding or expertise?);
 - b. plans for generating new fund sources;
 - c. principle service activities;
 - d. seasonality of the nonprofit’s operations;

- e. competitive conditions;
 - f. environmental matters;
 - g. any litigation and related legal issues.
- 6. Is the nonprofit in compliance with any relevant legal standards?
- 7. What are the major assets of the nonprofit and what condition are these assets in?
- 8. What opportunities exist to expand services? What would be the associated operational and financial risks and implications?
- 9. Were there any material ethical issues encountered by the nonprofit during the year? If so, how were these resolved?
- 10. What employee and management systems and resources are in place and how effective are they? (The CEO should also include in his report an analysis of the performance and competency of the nonprofit's staff -- either the TMT or the entire staff as appropriate -- as well as a compensation history of the nonprofit's employees.)
- 11. What is the current financial condition of the organization? (Explain the organization's liquidity, working capital, capital resources, results of operations, and fund raising or other income sources.)
- 12. For the CEO and any managers responsible for the accounting function:
 - a. Were there any issues material issues that arose in the development of the organization's financial statements?
 - b. Were there any management judgments involved in resolving those issues and developing those statements?
 - c. Have you certified conformance with all accounting requirements and that you have disclosed all material financial and operations information for the year to the auditors and to us, the board of directors of the nonprofit?
- 13. Does the organization's annual report for use with members, contributors, and the public, accurately reflect the nonprofit's mission and the use of funds?
- 14. Is there any other information regarding the organization that the TMT consider to be important for the directors to know in order to understand the services and

programs provided and to provide overall strategic and policy leadership of the organization and to make informed decisions?

EFFECTIVELY IMPLEMENTING TMT REPORTS

After the TMT reports are submitted, members of the TMT should individually meet with the board (and, any relevant board committees, if they exist) in order to review their reports, the nonprofit's operations for the year, and the 990 filing with the IRS. To help ensure frank discussions with each TMT member, directors should give serious consideration to establishing sessions between directors and the TMT members without the CEO being present. Directors will then be in a better position to evaluate the knowledge and competency of those who are responsible for various functions of the nonprofit, as well as the quality and completeness of the information in their annual reports to the board.

Boards of larger nonprofits may wish to consider establishing both an operations committee and a strategic planning committee so as to provide directors with sufficient opportunities throughout the year to receive more detailed the information from members of the TMT. The committees would concentrate on specific operational and strategic challenges throughout the year and enable directors to discuss with the TMT members and the CEO these important aspects of the nonprofit.

TMT members would need to devote sufficient time during the year to adequately prepare for and participate in committee meetings and develop annual reports. This will add to their workload but the benefits to the board should be substantial and should impel directors to likewise devote more time to considering material operational and strategic issues.

Effective implementation of TMT reports will require that directors and top managers "separate the people from the problem" (Fisher & Ury 1991). Information about important issues facing the nonprofit should not be biased or edited according to personal agenda. To the greatest degree possible, directors and top managers should aim to be critical about ideas rather than about individuals. As disagreements and conflicts inevitably arise, the board and TMT members should welcome cognitive conflict while discouraging

interpersonal conflict. Balancing these contending forces will help the organization to effectively process information while limiting potential conflicts among individuals.

Moreover, in all probability, this approach would fundamentally alter the relationship of the board to the CEO and TMT. The CEO of a nonprofit where the board requires officer reports would need to display maturity and trust that the board will not overstep its oversight responsibility and engage in activities that are the proper purview of the CEO. The CEO would also need to trust that the TMT members would not use the annual report and meeting with directors as an opportunity to attempt to undermine the CEO's position or distort his or her views or actions. Expanding the direct interaction between directors and executive officers through officer reports and meeting formats that include portions of the meetings without the CEO present will benefit the organization if the director and officer positions are occupied by confident, mature, thoughtful, and emotionally stable individuals who are comfortable in a working environment based on a team management approach as opposed to the traditional CEO-dominated approach. While there is real potential for problems to arise out of the disruption in the traditional CEO controlled relationships, this risk should be outweighed by a more focused board where directors have access to a broader source of information regarding the operations of the nonprofit and its financial condition and can gain the perspective of all of the members of the TMT. To the extent, then, that the board and TMT (including the CEO) can move beyond traditional, authoritarian relationships, TMT reports will help to develop the nonprofit into a "learning organization" (Senge 1990).

REQUIRING NONPROFIT DIRECTORS TO MAKE CERTIFICATIONS

The TMT reports we propose would be part of the operations of the board and would become part of the official record of the board. If board decisions were subsequently challenged, these records would be useful in establishing that the board had made decisions based on directors having received and considered information relevant to the issue as is required of them under their fiduciary duties of loyalty and care (Palmiter 2009).

In addition, the importance of the TMT reports in usefully informing director could be reinforced by having nonprofit directors sign a certification along the lines of the following and having the certificate be part of the board records:

“I have received, read, and understand the TMT reports for this year. I have asked members of management all of the questions I deem necessary to understand and use these reports in my duties as a director of this organization, and have received answers to these questions from management that are satisfactory to me.”

Such required certification, together with the team approach of a learning organization, will encourage thorough consideration of important information. In particular, required certification is likely to increase efforts by directors to actually use their knowledge and skills to advise and oversee the management of the organization (Forbes and Milliken 1999). There will be explicit focus on the information in the reports and the duties of directors to ask questions based on that information. The directors can then pursue areas that they are unclear about, need further information on, or need further training to better understand the issues at hand. This, in turn, may help to keep directors of nonprofit boards engaged in high-value activities.

CONCLUSION

The informational challenges of a nonprofit board can best be addressed if directors have information about the organization that is broad and deep and not solely dependent upon the nonprofit's CEO. Setting up a formal TMT reporting requirement and a review process that includes board and committee discussions with TMT members on a regular basis without the CEO present could be a powerful approach to counteracting a CEO-shaped information flow to the board. Implementing TMT reports would inevitably be a challenge for nonprofits as they would need to strike an effective balance between maintaining chief executive authority and creating a broader and deeper basis of information flow from the

members of the TMT. However, the traditional CEO-controlled approach to information flowing to directors can lead to inherent informational distortions or gaps, unintended or deliberate, that may arise out of the CEO's perspective and ability to control. Boards should avail themselves of the insights of other TMT individuals to balance the CEO-dominated view that directors will naturally receive throughout the year during meeting presentations and through periodic mailings. Receiving information from all the members of the TMT will naturally lessen the dependence on the CEO that boards often develop. This could dramatically improve information flow to directors who then would have a much richer understanding of the organization for which they have ultimate responsibility.

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