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*Due Diligence in the Evaluation of Nonprofit Financial Matters*

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Experiences with deceit by top managers of nonprofit organizations have made us conscious of the damaging effects of executive breaches of ethics. As a result, today there is an abundance of perfectly adequate ethical codes readily available to guide nonprofit executives and trustees in financial decision-making such as in fund-raising.

Perhaps the time has come for us to concentrate on diligence over such matters. Due diligence has to do with the obligation of trustees and managers to be informed and to exercise prudent judgment over all assets of the organization. This means that each manager or trustee must exhaust every effort to express an honest and informed judgment on all transactions that may materially impact the organization's welfare.

Existing ethical codes are not substitutes for diligence. To date, no one accuses the directors of Enron to have acted unethically. There is general belief, however, that they failed their duty of diligence and that this failure continues to result in severe financial hardship and widespread damage to the company, its investors, employees and its sector.

In like fashion, the failure of due diligence shook the foundations of the United Way and, recently the American Red Cross. In the former, the lack of diligence of the board over transactions enabled extensive unethical acts of an expansive executive. In the latter, the sufficient exercise of due diligence might have prevented the elaboration of promises not fully met but that were not illegal and were fully consistent with increasing the capacity of the organization to carry out its charitable mission. Due diligence, therefore, is an engine that drives both ethics and efficiency.

The issue of due diligence arises whenever a financial transaction generates questions such as: How could this have happened? How could this have gone undetected for so long? Why didn't they catch it? How can directors deny not knowing? Shouldn't they have known? Were they not sufficiently curious to have asked questions? Were they sleeping at the wheel? Were they not paying attention? How could they sign a document and claim not to know that it is inaccurate or incomplete? How, given past history, could they not have been alert? Are they finding a scapegoat in the hailstorm? Are they really that stupid?

The need for due diligence over financial matters is increasing. Indeed, the more

complex an organization and, the more successful we are in insisting on ethical behavior, the more important is due diligence to monitor and discipline financial decisions. As nonprofit transactions become more complex, the sharper and more informed this tool must be and the more it is incumbent on trustees and managers to acquire the curiosity, information and skill to evaluate strategic and financial decisions.

In many of these financial transactions ethical codes alone may give incorrect guidance. Take the fund-raising ratio commonly used as an ethical standard. These ratios are computed as the dollars raised in a given year divided by the dollars expended in that year. A high ratio, sometimes called yield, is assumed to be good. High ratios are often gotten without any ethical or professional breach.

But high fund-raising yields are often explainable not by current expenditures but by past expenditures in the years when managers are likely to have been criticized by donors, watchdog agencies, and unwitting trustees for having low ratios and failing ethical standards or best practices. This is so because today's fund-raising yield is often the product of years of cultivating contacts, channels of communications, and the confidence of donors. There may, as a result of accounting rules, be a delay between the promise of a donation and its recognition in the financial statement. Were these low-yield years so detrimental? Were they truly violations of ethics? Would the organization truly be better off by adherence to the standard? Here the issue is not one of ethics, but one in the exercise of due diligence – getting behind the ethical screen.

As ethical codes, acceptable professional practices are also no substitute for due diligence. For example, a manager (not just the accountant) may choose among several professionally acceptable ways to allocate shared or common costs between fund-raising and other activities. What percentage of the common costs goes to fund-raising and what percentage to the other activity will affect the fund-raising ratio. This is true even though the accounting profession has guidelines as to how common costs between fund-raising and education are to be shared. As I have discussed elsewhere, these professional rules can be satisfied through managerial strategies that are totally ethical and acceptable but each has a different impact on resulting ratios.

Due diligence is a strategy to reduce the risk of failure as well as the embarrassment of discovering what underlies spectacular success. Due diligence is driven by a quest for information and a curiosity to question. It is asking why, how and when and with what consequence even when choices are clearly ethical and results clearly satisfactory. Hence, it takes due diligence to determine if and when the choice that yields the best quantitative fund-raising yield ratio is preferable given an organization's strategic station. Due diligence is required even when all choices are acceptable.

How does an organization develop a culture of financial diligence among managers and trustees? Cultivating a culture of financial diligence is more akin to teaching art and music appreciation than of training accountants or financial officers. It is less the

teaching of how to do than it is why it is done and the ultimate aesthetic effects. It begins by recognizing the content of financial information just as the critic understands the material with which the artist must work.

But, as the successful artist must share his or her work and open it to viewing and criticism, so must financial information be shared and a tolerance for open and frank discussion be instilled; for unlike the audience, nonprofit managers and trustees are held legally and personally responsible for what they failed to see or hear and should have. Therefore, instilling a culture of diligence is about encouraging a dialogue about “what if” in the exploration of every financial or strategic decision. It must seek to understand both the operational and ethical implications of financial strategies.

Due diligence is a continuous process. In the budgeting process, for example, due diligence calls for explanations as why and how certain expenditures or revenue estimates are arrived at and how realistic they are. During the course of the year, variances from these estimates need to be assessed but with the intelligence that demands explanation not only for things that seem bad, but also for things that seem good. Due diligence goes beyond the numbers. It is not an exercise in arithmetic, but in logic. It is not about numbers but about meaning and implications.

Finally, due diligence is not motivated by concepts as competence, commitment, or confidence. The reason is simple. Due diligence requires the exercise of these. Thus, the appointment of a financial executive, or chief executive officer or a member to the board should occur only after the exercise of due diligence to establish confidence in his or her competence and commitment. Once the person is appointed, then, the exercise of due diligence should uncover whether such confidence continues to be warranted. These concepts are the result of, not the source of due diligence.

The legal source of due diligence is the duty of care. In virtually every state officers and trustees are legally required to oversee the transactions of a nonprofit organization and to make informed judgments about the use of the organization’s assets to raise, invest and to expend funds. Due diligence, therefore, is a central concept in nonprofit financial strategies and decision-making. The key is developing and sharing financial information, being able to assess that information, the curiosity to ask for explanations and additional information on a timely basis and the recognition that in the end, the failure of due diligence is costly. Perhaps we can learn from Enron.

Herrington J. Bryce, PhD, is the Life of Virginia Professor of Business Administration at the College of William & Mary. His book, Financial and Strategic Management for Nonprofit Organization: A Comprehensive Reference, Jossey Bass, 2000, explores these and other issues pertaining to non-profit finance and strategic management. Dr. Bryce is a member of NCNE’s Research Advisory Council.