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Fixing accounting isn't enough to deter deter scandals; heed the nonprofits

Much of the attention on the spectacular failures of Enron, and most recently WorldCom, has focused on accounting and the accounting firms. The Securities and Exchange Commission has proposed rules requiring that chief executive officers certify the accuracy of accounting statements, and it is considering rules to improve auditing.

While accounting is critically important to investors and reforms are essential, the fundamental failure in all three instances was internal. How were CEOs and boards of directors kept in the dark for so long? This is not an accounting or audit issue; this is an issue of ineffective financial governance.

While the public and nonprofit sectors are not often where we look for solutions to problems in the for-profit sector, the most effective nonprofits, and governments, too, have learned two lessons in financial governance that can be useful in all sectors:

- Numbers can suggest the presence of problems but they rarely tell you

When Enron kept meeting its profit targets, board members should have followed up by asking if management was meeting those targets in the way the budget anticipated. Such inquiries might have led to greater scrutiny of its tangled web of partnerships and revealed the underlying weakness in its core business.

WorldCom's capitalization of expenses should have resulted in reports showing that operating expenses were below what the budget said was needed to meet its operational goals. Correct accounting reports would have revealed this deception as a misclassification, a seemingly technical issue although with huge implications. But the real sin was that management and directors did not question why WorldCom expenses were so low if operational activity was as high as planned or claimed.

Tighter accounting rules are important and better disclosure is important. But boards usually fail, not by missing the trees, but by missing the forest. Financial reports cannot be an end in



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Any responses to the Enron and WorldCom mess that ignore these lessons will not produce fundamental change.

Nonprofits didn't come by these lessons overnight. Nonprofits learned how to use financial reporting and budgeting to engage the board in meaningful ways to make sure that all activities proceed as planned and effectively advance the highest priorities of the organization.

They started by changing the focus

enough to know what the problems are. Internal financial reporting that demands questioning and follow-up is essential.

- Budgets, not the audited financial statements, are the best tools for managing and overseeing the health of an organization.

themselves. They need to be a facilitator of questioning and dialogue about the big picture, which is the only picture a board can usefully assess and oversee.

A board that receives financial reports evaluating progress on specific goals and strategies and that participates in a budget process that adjusts and advances those strategies is a board that is engaged. Its members know what is important. They know the limitations of what management can do and they can react quickly when those limitations appear to be magically suspended by the accounting statements. Weak management and passive boards won't use these tools. Changing the accounting rules may help expose their failings, but looking at their budgeting and internal reporting may expose failings sooner.

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of their internal financial reporting. They realized that, although it is under the control of finance specialists, financial reporting exists primarily for use by nonfinancial managers and board members to provide early warning signs and to verify that business activities are occurring as intended and expected. Financial reports are useful only when they help the board to ensure that the organization's strategy makes sense and that progress is effective in advancing that strategy.

Effective nonprofit organizations next changed their behavior by transforming the budget process into their primary tool for setting priorities and assessing organizational performance. A board needs to be forward-looking and it must demand budgets that reveal priorities, explain strategy to deliver those priorities and provide transparent milestones and benchmarks that allow the board to assess the adequacy and appropriateness of management activities to effect their strategy and priorities.

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