The Not for Profit Sector and COVID-19

Covid contracts for directors on for profit and non profit boards

In this joint collaboration document from Arthur Cox and Davy, prepared exclusively for IoD members, we probe considerations for Directors of primarily Non-profit Boards. We have balanced this with a overview from Philip Smith at Arthur Cox regarding Directors duties and Ian Brady from Davy relating to broad financial sustainability and a planning framework towards stewarding non-profit assets.

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The same statutory duties apply under company law to a director of a company whether they are a remunerated director of a for-profit company or an unremunerated directors (a.k.a charity trustee) of a charitable company. However, the contrast in context in which directors fulfil their duties can lead to very different strategic aims and priorities for action.

The for-profit corporate world has a broad range of governance responsibilities, but these are all regarded through the lens of maintaining and improving shareholder financial returns. Charity trustees exercise the same responsibilities through the lens of delivering on the promotion of the charitable purpose for which the entity was established.

This section of the briefing looks at the contrasting priorities arising from the COVID-19 crisis and the potential learnings that diversity of profit and non-profit experience can bring to a board by examining five of the most relevant statutory duties for not-for-profit trustee directors in a post-Covid world.

1 To act in good faith in what the director considers to be the interests of the company.

In the for-profit world the interests of the company are at the simplest level the best financial interests of the company and all actions regarding staff, strategy, reputation and other governance aspects can in the event of any ambiguity be measured against that yardstick.

For non-charitable companies this duty is not confined to financial interests. However, the interests of charitable companies can be harder to identify given that they are linked to promotion of the objects.

The lesson for non-profits from the for-profit world is that while financial return is not the ultimate aim of a non-profit entity, fiscal prudence is essential in a time of uncertainty in order to maintain the resources to respond as flexibly as possible to mission-related demands. A fiscally imprudent or loss-making entity will not in the long-term promote any object as it will cease to be sustainable. Having the necessary financial experience to cope with the upheaval of COVID-19 is not a given; nor is it straightforward to re-align services with impacted budgets.

On the other hand, in order to continue the promotion of the objects it may be that the most financially efficient approach to the crisis which would be adopted by a for-profit company is simply not available to a non-profit counterpart because of the overriding requirement (subject of course to overall financial viability) to continue to fulfil one or more of the objects.

2 To act honestly and responsibly in relation to the company's affairs.

Environmental, Social and Corporate Governance (ESG) has once again become fashionable due in part to the increasing societal impact of climate change campaign. This is an area where many non-profit entities have quietly been standard bearers particularly with regard to the environmental and social aspects of ESG. In contrast the focus in the for-profit world has been more on the governance side through promotion of shareholder activism, shareholder rights and the various corporate governance codes.

COVID-19 has stress tested the resilience of both for-profit and non-profit boards alike. It has emphasised the merit of considering, measuring and monitoring risks and in maintaining appropriate governance procedures and policies for example around health and safety. The challenge of compliance with the various COVID-19 protocols varies from one organisation to the next but organisations which were fully conversant with their health and safety obligations, or had governance/risk sub-committees were better placed to respond to the challenges than those with weaker governance structures.

3 Exercise care, skill and diligence which would be exercised in same circumstances by a reasonable person.

Since the outbreak of Covid-19, many charities have faced liquidity challenges. Where insolvency is a significant risk, directors must prioritise financial planning to ensure the survival of the organisation. They should consider whether spending on non-essential projects can be delayed and, if the charity has reserves, whether now is the right time to utilise them.

Directors from a for-profit background who are serving on non-profit boards should be aware of the unique challenges that non-profits face when seeking financial support. Financial planning for charities is made more difficult by potential restrictions on charging charitable assets. The often unreliable nature of a non-profit's income (whether from delays in grant funding or variability of public fundraising) often rules out the possibility of overdraft facilities. Government funding requirements also often mitigate against the maintenance of appropriate reserves which can lead to a financial 'hand-to-mouth' existence. All of these factors mean that many non-profit entities suffer from a lack of financial resilience resulting in the COVID-19 crisis giving rise to significant challenges (either from difficulties in responding to a sudden loss of income; or challenges in scaling up activity to meet an unanticipated surge in demand for services).

At first sight experience from the for-profit world might suggest that a merger (with a more financially robust non-profit in the same sector) might provide a straightforward solution to financial distress. When considered in more detail merger (which is complex enough in the for-profit world) is often more complicated for non-profits. One of the key complicating aspects is that all for-profit entities are ultimately linked by the profit motive: non-profit entities do not have the same uniformity of overall priority. A non-profit cannot merge with another non-profit unless their objects, missions and programs sufficiently overlap.

4 To have regard to the interests of the company's employees in general and its members.

For non-profits, having regard to the interests of members equates to acting in the best interests of the promotion of the charitable purpose for which the company is established. In this regard there is a large difference in the focus of corporate governance (which in the for-profit world is concerned with the financial investment made by members and their associated rights). In the non-profit world the members are stewards of the application of assets towards the objects of the organisation. As such the interest is much less personal and not solely financial.

In considering employees it is important to note that many non-profits are assisted by volunteers and wider stakeholders to fundraise on their behalf. Most of the traditional ways of fundraising, such as community events involving a large congregation of people, cannot continue as they previously had done pre-Covid. Directors of charities will be responsible for ensuring that when fundraising resumes social distancing rules are observed and that the safety of participants is paramount.

5 To act in accordance with the company's constitution and exercise powers only for lawful purposes.

In facing the COVID-19 challenges non-profit directors must nevertheless continue to maintain proper corporate governance. Profit and non-profit boards alike must still compile their statutory books and records and hold member and director meetings in accordance with the constitutional and company law requirements. Whichever type of board you serve on, video-conferencing is here to stay.

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Financial Stewardship for Directors of Non-profit entities in a Covid World

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The difficult task given to Directors of Non-profit entities of stewarding finances can cause significant challenges. Good financial management may seem straight forward, but on occasion, certain elements at non-profits can be out of your control. Frequently non-profits are beholden to third party funders or open to the vagaries of the fundraising environment for a significant portion of their income line and their financial well-being. Similarly, non-profits also have to navigate the precarious world of surplus/deficit balance typically right on the edge of “comfortable” relative to their for-profit counterparties.

This section of the briefing examines financial sustainability as the core tenet of continuous service provision in a non-profit World as well as the challenges navigating a negative interest rate environment and articulates a framework for stewarding assets appropriately. A for-profit approach has merit for consideration in balance with non-profit financial stewardship and certain concepts. There are undeniably commonalities across both types of entity. Ultimately, as Philip Smiths’ contribution indicates, the Director’s duties are the same but the lens which non-profit Directors must examine their financial oversight responsibilities is different yet no less challenging.

1 Financial Sustainability

The ideal scenario for a non-profit entity involves operating in a world where the surplus and deficit dynamic is balanced in the long run and the non-profit is sufficiently buffered to navigate economic cycles and withstand shocks such as the one we are experiencing now in a Covid World.

Sustainability encompasses both financial sustainability (the ability to generate resources to meet the needs of the present without compromising the future) and programmatic sustainability (the ability to develop, mature and cycle out programs to be responsive to community requirements over time).

A profit (surplus) is fundamental to sustainability. As a Board it is important to be comfortable budgeting for a surplus so that you are operating with a sustainability orientation. The Boards job is to sustain the Purpose with a primary duty to enable the charity to be a stable, reliable provider of a community need regardless of the economy. Planning for a surplus will allow in time an expansion in your service delivery or indeed protect it during periods when funding may be challenged such as now in a Covid World. The value of using a multi-year financial sustainability plan to do this effectively cannot be overemphasized.

It is important that Directors consider the expected financial evolution of the non-profit. A key tenet to this will be the development of a risk-based Reserve policy that will be there to support the charity in difficult times. i.e. board designated reserves, restricted for predictable replacement costs, operating reserve & unrestricted reserves etc.

2 Stewarding Conservative Assets in a Negative Interest Rate Environment

Banks have recently announced that they will start imposing negative interest rates on deposits for corporates and non-profit entities amongst others, bringing focus to the cash balances that some entities hold. These funds are the lifeblood of sustainability and in truth are the security net to maintain continuity of service delivery in a non-profit context.

In truth, there has always been a cost for holding cash. To the extent that there may be a perception that cash has always carried a price in the form of opportunity cost

- Potentially foregoing strong capital market returns with cash that is surplus to short term needs.
- The real risk of loss of purchasing power and cash has a significant exposure to this cost.
- And now, negative interest rates for certain entities impose an explicit cost on what may be a default position for clients that may have been reluctant to make an investment decision.

There are myriad reasons why entities hold cash, the main motives being to meet short-term spending requirements and to be used as a reserve during turbulent times. Unquestionably, however, a considerable portion of uninvested cash is not needed to meet short-term spending requirements. The risk of not meeting your financial and strategic goals rises in proportion to the levels of uninvested surplus cash that is held as the cost of long-term needs increase over time.

Interest rate expectations are exceptionally well anchored with no material interest rate increases expected for several years – these costs are here to stay and that situation fundamentally poses many questions for Directors considering financial sustainability at their relevant organisation.

3 A Framework Towards Stewarding Assets Appropriately:

Investing is a deeply personal undertaking. A capital allocation framework helps you to 'begin with the end in mind', empowering you to take a step back to consider and set financial goals that link with your organisation's strategic intent and to understand the trade-offs you need to make in order to achieve them. In particular, the framework will help you understand how you can better align your assets (including your cash balance) with your strategic objectives.

Step 1: Start with gaining a profound understanding of your goals (strategic & financial) and understand the link between the two.

The first and most important step is to understand what your organisations' unique financial goals are and the resources available to achieve them.

Step 2: Segment capital relative to goals

Once all the information is collated, the building blocks of a plan can be assembled. This approach involves segmenting your goals around the key aspects of your organisation – apportioning your capital buckets of liquidity (for certainty), reserve (to meet core needs) and strategic (to fulfil ambitions) capital to align your organisations capital relative to your identified goals.

Step 3: Structuring and investments

Now you have a clear picture of what you want and when you want it, the next part of the plan is to ensure you have a suitable investment approach in place to achieve this. This involves implementing the correct structures to achieve your objectives, taking into account all of the variables (inflation, volatility, time horizon etc), with a view to maximising your organisations outcome at each risk level. Increasingly, at this level corporate values and broader sustainability is in focus and the importance of the onus on the Directors of non-profits to clarify that their investment structure matches their values is apparent.

Step 4: Ongoing Review and Monitoring

It is important to conduct ongoing strategic review and monitoring of your objectives and strategy to ensure you are on track to meet your organisation's goals. The plan you have in place can be amended as your organisation's situation changes or as unforeseen circumstances arise. From a governance viewpoint, Directors need a policy overseeing such assets. This "policy" would need to link to your own terms of reference and governance protocols. In its simplest, it could be a Reserves policy and in certain cases, a more detailed Investment Policy Statement may be required.

Summary:

Ultimately, the two-lens requirement on Directors of non-profits poses challenges and complexity, but invariably in a rewarding context. The challenge of linking Mission to Resources is a perpetual one; the two are inextricably linked. To be clear, no Mission can be achieved without Resources, but there needs to be balance.

By focusing on financial sustainability, the value of using a multi-year financial sustainability plan to do this effectively cannot be overemphasized. We work with Boards to craft a plan for sustainability with appropriate surplus generation a core component of the work we do together. Doing this work will ensure you are best placed to operate with a sustainability orientation, navigate economic cycles and challenging periods such as we are all experiencing and perhaps in time can expand/enhance service delivery.

Please note that this article is general in nature, and does not take account of your financial situation or investment objectives. It is not intended to constitute financial or legal advice. There are risks associated with putting any financial plan or strategy in place.

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