*Fiscal Accountability*

# Fiscal Responsibility versus Fiscal Accountability

The way in which fiscal responsibility is used is often a misnomer. It is most often used as who has ultimate authority to approve or carry out the tasks and activities to ensure fiscal responsibility. The dilemma with this approach is that it doesn’t ensure that fiscal responsibility has been achieved; only that it is clear who should have achieved it. To say this a little differently in terms of boards, the fact that the board has assumed the tasks of fiscal responsibility doesn’t assure that the board is acting in a responsible way. Therefore, it would be clearer if another term, fiscal accountability were used, which exclusively refers to assuring that the board has acted in a responsible way.

Unfortunately, traditional governance practices would accept the board carrying out fiscal actions as having met the conditions of fiscal responsibility. Policy Governance starts from another point of view. It is more important to identify what are acceptable fiscal actions and conditions than who is responsible for establishing the methods to achieve them. This identification of acceptable fiscal actions and conditions is best made through the methodology of establishing *Limitations*. It is hard to conceive of fiscal responsibility as an *End*, but it clearly a constraint.

Few non-Policy Governance boards have identified the boundary between what is acceptable and unacceptable for fiscal responsibility. When asked, they will illustrate the fact that they approve the budget, major purchases, and are actively involved in investments. Their rationale for achieving fiscal responsibility is that if it was a major financial consideration, they approved it. Unfortunately, they have little evidence that they acted responsibly or (to stay with the better word usage) accountable, only that they were responsible.

# Six Critical Fiscal Constraints

Many people are intimidated by numbers and in particular, financial numbers. The bigger the numbers are, the more intimidating they are. Unfortunately, we have created a highly complex system for measuring financial performance. This is partly because financial performance works with data that appears to be highly accurate – numbers - rather than more subjective measures such as feelings.

One of the values of Policy Governance is that it greatly simplifies the fiscal responsibility process because it moves from requiring boards to select which is the best answer to assuring that an acceptable answer has been selected. It takes a significantly higher level of skill to assure that the best answer has been selected than whether an acceptable answer has been selected. In fact, there is significant evidence that if the board is seeking to find the answer that maximizes financial performance rather than an answer that achieves acceptable financial performance, it will have significantly increased the risk to the organization.

In terms of Policy Governance, what are the acceptable conditions that define fiscal responsibility? There are least six that boards should consider. Obviously, depending on the industry, products, and services that an organization might provide, there may be additions to this list. However, this list is a great place from which to start and most boards should include all of these conditions as a part of their *Limitations*.

## Cash Flow

An often-overlooked fact is that cash flow is more important to organizational viability than any other financial measure. More organizations fail because of the lack of cash flow than the ability to make a profit. Yet cash flow is often not an issue that is high on a board’s list of conditions to review. Balance sheets and income statements usually are first for the review by the board, and cash flow is often secondary if not completely missed. Obviously, if a board is not looking at cash flow, it is unlikely that the board has set any *Limitations* or guidelines.

What are some of the questions that a board should ask about cash flow to guide their *Limitation* policies: What is unacceptable cash flow over what period? Does it just have to be a positive cash flow? Does it have to be positive over a 12-month period or are there monthly constraints as well? At what point does an unacceptable condition occur?

## Capital

Capital measures an organization’s ability to sustain a loss. The more capital, the more likely the organization will be able to survive an unexpected change or catastrophe, such as lawsuits, market swings, or a loss of a patent.

What questions does a board need to address so that it can be assured that it has adequate constraints on capital? First, how much is enough to survive a loss? How much is too much, in that resources that could be used elsewhere will be tied up as capital? Are there conditions that require more or less capital?

## Profit and Earnings

Profit and earnings measure the organization’s ability to manage its business effectively and tend to be a longer-term measure of the organization’s viability. Profit and earnings are probably one of the better understood financial measures.

The Board needs to decide what is an acceptable level of profit or earnings? What is the timeframe for this performance? Do they need to have annual as well as monthly constraints?

## An Accurate Representation of the Financial State of the Organization

One of the fallacies of financial information is that it is accurate. This occurs partly because financial data is composed of numbers, which appear to give great precision. For example, with little effort, financial data can be reported in fractions of a cent. Another factor is the Accounting Industry’s standardization of procedures and practices. This is not a bad thing, but it does make financial information appear to very accurate when instead it is very consistent. Through the Accounting Industries’ efforts theoretically, two accountants working with the same data should come up with the same results because they are both using the same procedures. Consistency is important; it just isn’t the same thing as accuracy.

Boards should be looking for a consistent and accurate *representation* of their financial state, especially with respect to Cash Flow, Capital, and Profit. The board needs to know that the information at which they are looking represents a realistic picture of how they are performing. Often the best way to achieve this assurance is through an independent auditor. However, depending on the size of the organization there may be more cost-efficient ways to achieve this assurance, but the question is always “Do the financial reports reflect an accurate representation of the financial state of the organization?”

## A View to the Future

Other than the annual budget, few boards investigate the future to assess what future performance might be like. In Policy Governance, this would be a severe oversight. Policy Governance strives to be forward-looking and therefore requires projections. Many financial adjustments need to be made early, or they will require radical actions later. The best way to assure that adjustments are made in a timely fashion is to project future performance. Boards need to have advance warning that the organization will or will not comply with cash flow, capital, and profit performance measures. Waiting until *Limitations* have been exceeded may cause more financial loss and may result in an uncorrectable situation. Boards should require a steady stream of timely projections that show the organization’s performance related to the *Financial Limitations*.

One concern that is raised about projecting performance is that it is a guess and not real. This is true, but a guess or at least a realistic guess is better than assuming that everything is OK. At least the guess can be judged as to whether it is a realistic guess and then used to measure future compliance with *Limitations*.

## Monitoring and Corrective Actions

There has been much written on the need for Monitoring to create accountability. It will not be repeated here other than to say that accountability doesn’t exist without monitoring. What has not drawn much attention is the need for corrective actions. If monitoring only illustrates that there is non-compliance with a *Limitation*, monitoring has little value. Monitoring only makes a significant impact on performance when corrective actions are required to reestablish compliance. Boards must embed not only monitoring in their governance but the expectation for corrective actions as well.

## What is a Board’s Fiscal Accountability?

What should be clear is that a Board’s Fiscal Accountability is not to “do” or make the financial decisions, but rather to assure that they are made in a way that accomplishes the *Ends* and avoids non-compliance with the *Limitations*.