



Sobel & Co., LLC

**CERTIFIED PUBLIC ACCOUNTANTS
AND CONSULTANTS**

**Nonprofit Board Governance:
What Does It Mean?**

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I. Introduction: The History of Board Governance for the Nonprofit Sector

There has been increasing interest over the last several years in the composition, conduct and decision-making of nonprofit governing boards. This trend was further escalated by the passage of the Sarbanes-Oxley Act (“SOX”) in 2002 when the United States Congress radically altered the landscape for both the for-profit and not-for-profit sectors in this country. The direct result of the public outcry that came with the revelation of gross corporate misconduct, such as the Enron-Andersen debacle, WorldCom and Adelphi, to name a few of the more famous cases, “SOX” was designed to create a series of mandated behaviors that would reinforce the public’s trust and ensure transparency, objectivity and truthful financial reporting. In fact, the nonprofit world itself has endured its own version of a corporate “black eye” in the not so distant past, including some United Way scandals and other improprieties specifically in the nonprofit healthcare system. As a remedy to this behavior, which it saw as pervasive across the nonprofit and for profit communities, the government provided a complex list of guidelines for establishing the internal controls necessary to support a code of ethics for all organizations through the enactment of SOX.

While the original intent was to reassure the public, the financial community, the shareholders and the rest of the world that publicly-held corporations would be held to high standards that would be enforceable by law, the ‘trickle down’ effect of SOX has had an impact on the nonprofit community as well.

Further proof of this major shift in attitude is seen in the August 2007 press release issued by Jerald Jacobs, head of the Nonprofit Organizations’ Practice Group in Washington D.C. for the law firm of Pillsbury Winthrop Shaw Pittman LLP. This memo substantiates these changes with this one sentence: “Responding to unprecedented stakeholder demands for greater accountability, transparency and internal financial controls, nonprofit groups are adopting strenuous new governance measures previously associated with business corporations.”

Thus it is that the greatest influence of SOX on the nonprofit community can be seen in the development of best practices for board governance that are being embraced by the

various charitable and social organizations, associations and foundations that constitute the world of nonprofits. As nonprofits reconsider their behavior, they are adopting more stringent governance policies, avoiding conflict of interest issues, claims of self-dealing, neglect or incompetence and, at the same time, tightening their accounting processes. They are focusing on reviewing and updating all of their internal controls, risk management procedures, operations, financial reporting, accounting processes, legal compliance and even succession planning. As more procedures are borrowed from the corporate community, nonprofits are gaining a new level of trust from donors, users and members.

It is clearer now than ever before that serving on a nonprofit board is not something entered into frivolously as a way to build-up a professional resume. Instead, it involves behaving as a steward of the public, with expectations to carry out the organization's goals and ensure adherence to its principles. Board membership carries with it the obligation to be informed, enlightened and to behave in a competent manner. Equally as important, board members have not only moral, but legal obligations to carry out the mission of the group as well.

II. Gaining an Understanding of Board Governance: The Basic Components

Nonprofit board governance, an area that has been long neglected, is suddenly in the spotlight. As any nonprofit organization moves more consistently toward instituting SOX reforms, the first thing to be done is conduct an honest self-evaluation.

Looking inward, the board should consider the processes currently in place and decide if there are sufficient controls and compliance mechanisms to comply with the intent of SOX as well as their own core values. The evaluation should include a review of (1) the code of ethics, (2) the mission and vision statements, (3) board behavior and (4) of the standing committees, among them the finance and audit committees. These two committees are critical because with improved financial reporting comes the need for more involvement from the board over the accounting processes and the financial reports.

The review should include, but not be limited to, the operating budget, the capital budget, the reserve fund (see the Sobel & Co. white paper on Reserve Funds published in 2007), records of all transactions, activities by the committees and staff and establishment of internal controls and personnel policies and documentation.

Most of the research and studies currently being conducted regarding board governance focus on four key areas: board composition; relationships between the board and the staff; roles and responsibilities of the board; and lastly, correlation between the effectiveness of the board and the organization's overall effectiveness.

Board composition

Most nonprofit boards are comprised of people who have a particular interest or passion for the nonprofit's mission. This can be seen especially among smaller, local nonprofits which have begun to purposely invite participation on their board from those who best represent their neighborhood and their clients, thus creating greater diversity and building strong connections to those they serve. As this notion of *community representation* takes hold, boards will find themselves less the playground of the rich

philanthropist or upwardly mobile professional looking to climb the social ladder, and more the place where people roll up their sleeves and accomplish real work – whether that is erecting affordable homes, supporting homeless shelters, or encouraging the greening of the planet. This shift is refreshing, but it means carefully educating the board members to understand the responsibilities they have assumed.

The board composition is shifting in many cases in response to the shift from 'trustee' to the 'director' model for nonprofit boards. In the past, many states viewed nonprofit board members as trustees of a public trust. Under this trustee model, courts could hold board members personally liable for simple negligence *or* gross negligence. Yet courts could hold corporate directors personally liable *only* for gross negligence. So nonprofit trustees were being held to a higher standard from corporate directors! The implementation of the the new model means that nonprofit board members are viewed not as trustees - but as directors - with responsibilities like their counterparts on for-profit boards. This transition to a more corporate model has changed the legal ramifications for board members as well as changing the way nonprofits see themselves, and influencing their public image at the same time.

Board-staff relationships

It is important for the board to have a good working relationship with the staff for obvious reasons. The board sets the mission, vision and tone for the organization, but it is the staff that implements the programs that make it possible for the nonprofit to achieve its goals.

There are many factors that contribute to ineffective interaction and poor communication between board and staff. Volunteers need to be reminded that they should not be involved in the day-to-day management of the organization, as this is the staff's domain. Instead, they should redirect their time and resources to strategic planning, fundraising and advocacy. No matter what, though, it is critical that the board retains total accountability for the organization and total authority over it. The job of the board should not be abdicated to the Executive Director (ED), but rather the ED is a subordinate to the board. This is further complicated if the ED is also the Founder, but the same guidelines must apply. Those boards that encourage the Executive Director to assume a greater role, such as creating the board agendas, overcoming dissension, and orienting new

board members, create a situation where board irresponsibility flourishes and the power of the ED is in inverse proportion to what it should be.

On the other side of the same coin, the staff has major challenges as well. Volunteer boards turnover with planned regularity and the staff is expected to adjust to the constant change in personalities, leadership styles and demands of the new board members, board chairs and committee leaders. The staff's perspective must be understood by the board. Because so many nonprofits (especially the smaller, regional groups) have restrictive budgets, they cannot afford the salary that is common in the corporate market. Instead, they attract staff that has a commitment to the cause rather than focusing solely on their paycheck. The reality is that this often translates into recruiting younger, less experienced staff and enduring a low retention rate as frustration, reality, or disillusionment kicks in.

The board needs to be respectful of this reality, while establishing ways to help the staff be successful. This is done by clearly defining roles and expectations and delegating authority to execute specific tasks. The final step is to confirm that expectations are being met. A board that establishes goals and assigns tasks - but refrains from providing oversight, such as monitoring and evaluating the activities - is only performing one half of their full role.

For those board members who overstep their bounds, or who under perform in areas where they do have a role to play, it is essential that they have a clear picture of what board governance is all about. The board needs to be able to make the distinction that allows them to walk a fine line, empowering the staff by giving them room for creativity, flexibility and innovation without giving up control of the organization's purpose.

Since board responsibilities may be different for each nonprofit, they need to be carefully defined and frequently examined for relevancy and effectiveness.

Board responsibilities

Because of the informal approach to board governance that has been the hallmark of the nonprofit sector, each organization has historically been left to its own devices regarding the definition of its board's responsibilities. Yet, we all know that a highly functioning

board is the single most important key to the organization's success and sustainability. So why leave this to chance?

Just a little more than a decade ago, Chait, Holland and Trucker wrote, "Effective governance by a board of trustees is a relatively rare and unnatural act...trustees are little more than high-powered, well-intentioned people engaged in low-level activities." It is often documented that boards, while comprised of smart people, have a reputation for not behaving smartly. Peter Drucker, the highly regarded author and lecturer, summed it up with these words. "There is one thing all boards have in common...they do not function." This negligent behavior, which was the accepted nonprofit model for centuries, has made it more difficult to affect real change regarding board governance. But as SOX has evolved, more of the boards are being held accountable and are expected to behave according to more professional standards. Nonprofit boards are trying to catch up to their corporate counterparts. It is not a simple task. As Bryson and Crosby warn their readers in "Strategic Planning for Nonprofit Boards, "Both individually and as a group, a board needs to be able to leave behind old paradigms of thinking, feeling and acting, to move into uncharted territory."

To make this transformation, the board members must first understand and accept that they are the voice of their members, of their communities, of their donors and of the users of their services. As 'servants' they should spend more time focused externally, acting as representatives and advocates for the group.

Applying their trademarked Policy Governance Model, John and Miriam Carver have said it most succinctly: "The board's main role is to govern in an organized, planned and highly disciplined manner." But how is this actually accomplished?

The board members must be well-informed, knowledgeable and armed with alternative scenarios. To help every board establish a basic criteria for its members that will ensure they are knowledgeable and informed, here is a list of categories where members should be expected to be both involved and responsible:

- *Set the policy for the organization.* This is done by writing the mission and vision statements, writing a strategic plan to support the mission and selecting the programs and services that accomplish the stated goals.

- *Monitor (not perform) operations.* This is done by hiring and evaluating the executive director and ultimate oversight of the staff and of the office processes and policies.
- *Establish appropriate fiscal policies of the organization.* This is done by approving the annual report and budget and working with the external auditor, approving grants and contracts and evaluating the financial success of all programs and fundraising activities.
- *Serve as a public figure for the organization.* This is done by acting as its advocate in the public domain, making personal contributions and soliciting donations from others.
- *Fulfill other, less defined, roles.* This is done by preparing and attending board meetings, documenting policies to create an institutional history, replacing and orienting board members, acting in accordance with the mission, acting in the best interests of the organization and being prepared to stand aside if there is a personal conflict of interest.

There are additional board responsibilities that should not be overlooked. Writing for the *Puget Sound Business Journal*, Geoff Longmeier has reminded all board members that whether they are serving on the board of a foundation, endowment, or nonprofit organization, if the organization has money to invest, they will have investment-related fiduciary responsibilities to fulfill that include the following categories:

1. Standards, laws and trust provisions. As a fiduciary, board members are required to know the law.
2. Board responsibilities. The board holds ultimate responsibility for the oversight of an organization's investments, although they may delegate to finance committee or outside advisers.
3. Investment policy statement. All organizations that oversee investment portfolios should have a written investment policy statement.
4. Structure of investments. The investment portfolio should be carefully structured to meet the needs and restrictions of the investor, as detailed in the investment policy.
5. Use of investment advisers and other professionals. Legislation does not require fiduciaries to use outside professionals, but it is often highly prudent to do so.
6. Fees and expenses. Fiduciaries should look at all dollars spent on investment services, whether paid directly or indirectly, including fees paid to consultants and investment managers, transaction fees, mutual fund expenses, referral or other sales fees.

7. Evaluating performance. Procedures to monitor investment managers and portfolio performance are typically outlined in the investment policy statement.
8. Conflicts of interest. One potential conflict is when a board member is also affiliated with a firm that provides investment services to the organization.

From this discussion, it is obvious that extraordinary boards do not just 'happen.' Extraordinary board members face a significant amount of challenging work, make a sincere commitment, and spend time and resources satisfying the responsibilities outlined here - but the results are worth it.

The correlation between the effectiveness of the board and the organization's overall effectiveness.

The board's responsibilities listed above seem straightforward and obvious, but are surprisingly often ignored. The outcome then, is that the organization's overall effectiveness diminishes in direct correlation to the board's ineffectiveness.

For example, assuming a 'strategic role' requires an investment of time that busy board members may not have. To overcome this dilemma, some boards schedule periodic strategic planning sessions. A full or half day retreat, perhaps annually or every other year, allows board members to clear their minds of other, outside responsibilities and focus exclusively on the issues – both short and long term – that the organization faces.

Additional problems arise that impact the organization's effectiveness when board members miss meetings or arrive unprepared, having not yet even reviewed the minutes of previous meetings or other key documents. This means that meeting agendas are filled with "committee reports" rather than with high level, more strategic conversations that are needed to keep the organization fresh and relevant for its constituents. Some organizations require board members to sign a 'contract' regarding their commitment promising to make time to attend a specific number of meetings as well as a guarantee that they will be prepared. No matter how this is enforced, if board members miss meetings regularly, the organization becomes stagnant. Important decisions cannot be reached without robust discussions and the participation of all board members. The time spent together becomes a re-hash of all the previous discussions as they attempt to

bring missing members up to speed. The bottom line is that all too frequently boards do not have time to act in the proactive manner that allows them to add real value.

Compliance and performance are separate actions, and both are important for success. As board actions are assessed and members are periodically evaluated, bold action may need to be taken to heighten performance and raise the bar on the nonprofit's performance. Under the guidelines of SOX, it is easier now to hold the board members 'feet to the fire,' define their legal and ethical obligations and set expectations for them to carry out their responsibilities in a timely fashion.

No matter how informal the nonprofit's culture is, the board members should perform their duties according to the best practices. They can start by defining their role in terms of the organization itself and its broader public purpose as they move forward to identify and implement those actions that will help the organization function more effectively and efficiently.

If a board determines that it requires outside assistance with this, there are numerous consultants who assist boards in defining their responsibilities and making these a reality.

III. Trends: More Changes on the Horizon

While for-profit companies and not-for-profit organizations grapple with the challenges presented by the Sarbanes Oxley Act, even tighter regulations and more demanding reports are eminent. In December 2007, the Internal Revenue Service released the newly revised Form 990. In light of the current circumstances, long overdue, sweeping changes have been made that will impact the way nonprofits report on finances, leadership, activities, and most critical for this research paper, governance practices.

The New 990 Impact on Governance and Operations

Beginning with the 2008 returns which will be filed in 2009, most nonprofits must use the new Form 990. It should be noted, though, that the IRS will allow a graduated transition period for smaller non-profits which can use the less onerous Form 990-EZ for a period of time.

The form itself not only changes the way nonprofits report information, but the way they categorize the organization's activities. Under the new form, nonprofits will be required to disclose certain organizational practices, including how executive compensation is established. The form forces the nonprofit to think more like a corporation – to act and report in a more professional, formal manner, such as by making governing documents, financial statements and conflict of interest policies available to the public. Under these new reporting standards, nonprofits will have to indicate:

1. If they document meetings and actions as they are occurring, or immediately after the fact.
2. If they have a conflict of interest policy that is monitored and enforced – and documented proof of such enforcement.
3. If there is an established whistleblower policy and proof of how the allegations are reviewed and resolved.
4. If there are document retention and document destruction policies in place.

Along with these specific guidelines within the core form, Schedule O asks the nonprofit to describe the process by which the organization's governing body (the board) reviewed the actual Form 990 prior to filing. This action ensures board member participation in the process. It is clearly not acceptable for board members to hide behind the "I did not know" excuse. Like their corporate counterparts, nonprofit board members are being

held to high standards and are asked to document their involvement in the decision making process.

Noncompliance is a Non-Issue

The result of filing an incomplete or inaccurate Form 990 will be severe. Not only will the organization face IRS penalties but they will be exposed to public scrutiny since the Form 990 is easily available to the general public. As far as board responsibilities as discussed in Section II, this goes one step further in raising the level of expectations of the board members and the organization's governance policies.

IV. Conclusion

A serious approach to nonprofit board governance is no longer optional. Indeed, the concept of boards behaving in good faith, applying a professional, disciplined approach has arrived - and it is here to stay. The organization benefits from having an engaged board, one that assumes responsibilities and acts as an advocate for the mission, working in concert with each other and the staff to attain the stated objectives.

Over the years, in reaction to many different issues in the business and nonprofit communities, the expectations have grown that nonprofit boards, like their for-profit colleagues, will be responsible for the integrity and accuracy of the organization's finances. Establishing committees is imperative to carry out this work. These can include the governance committee, the nominating committee, the audit committee, the finance committee, and the ethics committee. While a smaller organization may choose to combine some of these tasks based on their circumstances, level of sophistication, size and available resources, the work of the committees must be accomplished for the sake of the organization's future.

Nonprofit organizations today require members that are thoughtful, deliberate and committed, willing to assume their defined roles, to follow best practices, to make a contribution to shaping the organization, and to adopt the concepts of responsible governance.

If your organization can make this happen – or start on the right path today – you will prevail!

V. Resources Cited

While conducting the research for this white paper, several websites and resources were examined. These include, but are not limited to:

“Best Practices: Nonprofit Corporate Governance,” published by the law firm of McDermott, Will & Emery.

www.bizjournals.com/seattle

“Sarbanes-Oxley and Corporate Governance of NonProfits” by Francis J. Serbaroli, published in *The New York Law Journal*.

“Nonprofit Corporate Governance – Playing the Game by the Rules,” by Dr. Richard S. Wallace.

“Carver’s Policy Governance Model for Nonprofit Organizations” by John and Miriam Carver. Found at www.carvbergovernance.com.

“Governance for Nonprofit Organizations: From Little Leagues to Big Universities,” published at www.governanceprofessionals.org.

“Nonprofits Increasingly Adopt Corporate Governance Models,” a press release by Pillsbury Winthrop Shaw Pittman LLP as published on their website, www.pillsburylaw.com.

“Excelling as a High Performing Non-Profit Board,” prepared by Peter A. Levy, Esq., Partner in Charge of Sobel Consulting Group, and presented at the William Paterson University Non-Profit and Faith Based Conference.

“Nonprofit Board Responsibilities; Overview of Non-profit Board Governance” by Estela Kennen.

“Nonprofit Board Governance: What We Know, Where We Should Go,” by Melissa M. Stone, presented as the keynote address at the University of Missouri-Kansas City Conference on Governance.

“Form 990 Redesign Poses Challenges” printed in *Nonprofit Insights*, A newsletter for Nonprofit Decision Makers, Spring 2008.

www.findarticles.com www.gsb.stanford.edu

VI. About the Authors

Ron Matan

Ron Matan, Member in Charge of Sobel & Co.'s Nonprofit and Social Services Group, brings a unique blend of public accounting and business acumen to every client engagement. A key member of Sobel & Co.'s leadership team since joining the firm in 1997, Ron works primarily with non-profit organizations, including United States Department of Housing and Urban Development ("HUD") projects, A-133 engagements, and low income housing tax credit programs ("LIHTC").

Professional credentials

Ron is a Certified Public Accountant licensed to practice in New Jersey, New York and Pennsylvania. He is a member of the American Institute of Certified Public Accountants and the New Jersey Society of Certified Public Accountants (NJSCPA). Ron has been elected to the PKF North America Network's Nonprofit Committee, and in June 2004, Ron was appointed to the New Jersey Society of Certified Public Accountants Peer Review Executive Committee. Ron is also a member of the NJSCPA's Nonprofit Interest Group.

Ron, as Member in Charge of the firm's Nonprofit and Social Services Group (audits of A-133, HUD and LIHTC programs), is responsible for the firm-wide quality of this practice area and is the firm liaison for the AICPA's Government (Nonprofit) Audit Quality Center. With over 30 years experience of public accounting and private industry experience with all types of nonprofit and social service organizations, Ron brings a unique blend of experience and insight to these specialized engagements. Ron is a Certified Tax Credit Compliance Professional and is listed in the Guide which is circulated to all State Agencies Allocating Tax Credits as well as the Internal Revenue Service. He also has taken courses in advanced training for peer reviews and performs peer reviews of other accounting firms.

Philanthropic and social service commitment

Ron is a member of the Board of Directors of First Occupational Center where he serves as Treasurer and is a member of the Education Committee for the New Jersey Chapter of the Society for Association Executives (NJSAE). Ron has been appointed to the Plainfield Neighborhood Health Center Board and Union County Educational Services Foundation Board. Ron was the former treasurer and board member of Kids Peace Treatment Centers for emotionally disturbed children, located in Bethlehem, Pennsylvania.

Educational background

Ron is a graduate of Kings College in Wilkes-Barre, Pennsylvania, where he received a Bachelor of Science Degree in Accounting.

Ron and his family reside in Bethlehem Township, Pennsylvania.

VII. About Sobel & Co., LLC

Sobel & Co. is a middle market accounting and consulting firm with headquarters in Livingston, New Jersey. The firm has been providing nonprofit and social service organizations in the metropolitan area of New York/New Jersey with audit, accounting, tax and advisory services since its inception in 1956.

The firm currently works with more than 150 nonprofit organizations with revenues ranging from \$100,000 to over \$60,000,000. Based on this depth of experience, the professionals in the nonprofit group are keenly familiar with the issues facing nonprofits and they will apply this knowledge to bring added value to every engagement.

As a further demonstration of the firm's commitment to the nonprofit community, several complimentary programs are offered throughout the year. These include quarterly webinars, roundtable discussions and an annual symposium on timely and relevant topics. Newsletters, articles, benchmark reports, surveys and white papers are also distributed to the nonprofit sector to provide them with access to cutting edge information.

Additional information about Sobel & Co. can be found on the firm's website at www.sobel-cpa.com. Please click "niches" and "nonprofit" to access a wide range of distinctive resources for your nonprofit organization.

