Complying with the New IRS Corporate Governance Guidelines for 501(c)(3) Organizations: Fiduciary Duty of Board of Directors to Oversee Financial Affairs

1. Need for Financial Oversight

Corporate governance has been an important issue on the national agenda since the Enron scandal, which prompted the enactment of the Sarbanes-Oxley Act of 2002 (SOX). SOX dramatically improved the corporate governance standard of publicly-traded companies by, among other things, requiring the Securities and Exchange Commission and other regulators to enact a large number of corporate governance reforms. These reforms primarily relate to the financial affairs of public companies, including financial auditing, compensation of executives, disclosures of material financial information and stricter fiduciary duty of boards of directors to oversee financial affairs.

Most corporate governance principles of these reforms have not applied to not-for-profit organizations because of their exempted status under various statutes. However, in response to an increasing number of high-profile scandals involving not-for-profit organizations, and in order to ferret out improper practices and to encourage good organizational governance, the Internal Revenue Service (IRS) has redesigned the Form 990, the annual tax return filed by not-for-profit organizations. These revisions have focused in large part on financial disclosure. For example, the revised form asks:

- Were the organization's financial statements prepared by an independent accountant?
- Does the organization have an audit committee that is responsible for the selection of the independent accountant?
- Does the audit committee oversee the work of the independent accountant in conducting the audit, review, or compilation of the organization's financial statements?
- Did the organization's governing body review the Form 990 before it was filed and what procedures did it follow to review the Form 990?

Several states have also started extending these corporate governance principles once only applicable to public

companies to cover not-for-profit organizations. Moreover, in most cases, it is now the expectation of donors, grant-makers and members that not-for-profit organizations follow these good governance principles and that not-for-profit boards exercise stronger oversight over the financial affairs of the organizations.

2. Role of the Board

One of the main focuses of the not-for-profit governance reform is to reorient not-for-profit boards as to their proper role with respect to the oversight of the management and operation of their organizations. This is due to the fact that in most high-profile scandals involving not-for-profit organizations the boards either have acquiesced to or have been unaware of the illegality or impropriety of certain financial activities, such as paying excessive compensation and perks; allowing personal use of the organization's assets; improperly accounting for revenue and expenses; and allowing other acts of financial mismanagement.

In contrast to the board members of a for-profit organization, not-for-profit board members more often are donors or fundraisers of the not-for-profit organization or have familial, business or organizational ties with the not-for-profit organization or other members of the organization. Consequently, these board members may be less inclined to question or criticize questionable actions or recommendations of the board or management. The revised Form 990 asks whether any director has a familial or business relationship with any other director. Although such relationships are not improper, their existence can create the appearance of favoritism.

It is important for any board that includes members with such relationships to review its oversight practices to ensure that it can document procedures for review and approval of financial decision making. In order to ensure that the board is an effective overseer of the operations and management of not-for-profit organizations and is able to exercise a more in-depth, informed and objective oversight role, the IRS focuses on the size of the board and the role of independent directors. On the Form 990, not-for-profit organizations must disclose the number of members of the governing body and the number of independent members of the governing body.

a. Size of the Board

A not-for-profit board should have an appropriate number of members to conduct effective oversight. A board with too few members may not have sufficient resources for proper oversight. With an overly large board, individual directors may have less sense of responsibility for overseeing financial affairs of the organization. Some not-for-profit organizations have large boards in order to increase donations and fundraising because contributing money to the organization is often the expectation or incentive of not-for-profit board members. However, in the wake of recent scandals, more effective "working" boards are desired and are deemed to be a sign of good practice.

b. Independent Directors

Not only the size of the board, but also the existence and the number of independent directors, has become more important. Inspired by SOX related reforms for public companies, having a majority of independent directors on a not-for-profit board is considered sound practice because it is viewed as evidence that the board has the ability to make independent decisions that are in the best interests of the organization.

In a for-profit organization, a director's independence generally means that the director does not receive compensation from the not-for-profit organization other than as a director, is not affiliated with management and has no personal interest in a specific transaction. (See previous legal alert entitled "**INDEPENDENT DIRECTORS AND TAX-EXEMPT ORGANIZATIONS," February 2008)**

The existence of a personal interest may influence a transaction directly–for example, there is a risk that a director who supplies goods or services to the not-for-profit organization may be awarded a contract on terms more favorable to the contractor (and accordingly, less favorable to the organization) than the terms that would be obtained from an unaffiliated third party. There is also a risk of more indirect influence. For example, that director may not voice his or her dissent to improper board actions for fear of losing a customer.

To guard against these risks and the appearance of improper decision making, it is deemed good governance practice to have independent directors on the board and also to institute a conflict of interest policy so that directors with personal interests in specific transactions are excluded from decision making on those matters and there is documented objective evidence of the fairness of the decision making process. (See previous legal alert entitled "**TAX-EXEMPT ORGANIZATIONS SHOULD CONSIDER ADOPTING CONFLICT OF INTEREST POLICIES," July 2006)**

For most not-for-profit organizations filing Form 990, it is considered a good governance practice to have a majority of independent directors on their boards. The underlying rational of this principle is that independent and non-management board members are better situated to exercise objective and unbiased judgment in board decision-making and therefore can enhance the board's ability to oversee the operation and management of the organization and to make ethical decisions in the best interests of the organization. In any case, each member of the board of directors of a not-for-profit organization, whether or not he or she is independent, should understand and fulfill the board's obligations by objectively evaluating the materials and information provided to him or her, overseeing financial matters of the organization, and making decisions in the best interest of the organization.

3. Financial Statements

A complete and accurate financial statement that is prepared in accordance with generally accepted accounting principles and auditing standards is essential for a not-for-profit organization to fulfill its legal responsibilities and for its board of directors to exercise appropriate oversight of the organization's financial resources. Thus, a board that does not have members with

financial expertise should retain a qualified accounting professional to prepare and review its financial statements.

Many small not-for-profit organizations do not have their financial statements fully audited by an independent accountant. Instead they use independent accountants only to review or compile their financial statements. However, for most not-for-profit organizations who file Form 990, it is deemed more appropriate to have their financials audited by an independent accountant. The redesigned Form 990 asks whether an independent accountant compiled, reviewed or audited the organization's financial statements. The IRS has indicated that if a not-for-profit organization is unable to answer affirmatively to this question, its management controls may be suspect, and it will be more likely to be audited by the IRS.

In addition, a not-for-profit organization with significant financial resources should have an audit committee composed solely of independent directors, whose function is to ensure the independence of the organization's financial auditors, review the organization's critical accounting policies and decisions, and oversee the accuracy of its financial statements and reports. An audit committee can provide the board with greater assurance that the audit has been conducted appropriately.

4. The Board's Obligation to Institute Policies and Procedures to Ensure Sound Financial Management

Assuring sound financial management is among the most important responsibilities of the board of directors. The board should establish clear policies and procedures to protect the organization's financial assets.

a. Day-to-day Financial Management

Day-to-day accounting and financial management should be delegated to staff (or in the case of organizations with no staff members, volunteers) who have the necessary skills. The board must establish a policy and procedure to assure that at least two people (either staff members or volunteers) bear the responsibility for receiving, depositing, and spending its funds. The board is also responsible for reviewing practices and reports to ensure that the staff members or volunteers are complying with the board-approved policies.

The board should also receive regular financial reports either monthly or quarterly. (Speak to your accountant for its recommendation.) The reports should show budgeted and actual expenditures as well as budgeted and actual revenues. By carefully reviewing the regular financial reports, the board will be able to determine whether adjustments must be made in spending to accommodate changes in revenues.

b. Budget and Expenses

The board of directors should review and approve the organization's annual budget and should monitor actual expenses and performance of the organization's financial assets against the budget to determine whether the organization is allocating its funds appropriately. Prudent financial oversight requires that the board look beyond monthly or annual financial

reports to consider how the organization's current financial performance compares with that of previous years and how its financial future appears. If the organization's net assets have been declining over a period of years, or if future funding seems likely to decrease significantly, the board may need to take proper steps to achieve or maintain the financial stability of the organization.

c. Prudent Investment of Financial Assets

Not-for-profit boards have the obligation to establish policies and procedures to ensure that their organizations manage and invest their funds responsibly in compliance with all legal requirements. In particular, a board of a not-for-profit organization that has significant reserves should have policies and procedures to ensure prudent investment of its funds. The board is responsible for establishing policies that govern how the funds will be invested and how the returns from investments should be allocated for different purposes. In some cases, the boards of not-for-profit organizations with sizeable reserves should select one or more independent investment managers to handle the organization's investment. Under these circumstances, the board or a committee of the board should monitor the outside investment managers regularly.

d. Expenses and Compensation

Boards of not-for-profit organizations should establish clear written policies and procedures to review and approve the payment and reimbursement of expenses incurred by anyone conducting business on behalf of the organizations, including travel expenses. As a general matter, not-for-profit organizations should not pay for travel expenses incurred by spouses or others who are accompanying someone conducting business on behalf of the organizations. In addition, the best governance practice is to have independent directors who are not affiliated with management determine the compensation of executive officers and staff members, and ensure the compensation decisions are tied to the job performances. (See previous legal alert entitled "**IN SETTING EXECUTIVE COMPENSATION, A TAX-EXEMPT ORGANIZATION SHOULD CONSIDER FOLLOWING THE IRS'S REQUIRMENTS TO ESTABLISH A REBUTTABLE PRESUMPTION THAT THE COMPENSATION IS REASONABLE**," **June 2007**)

Not-for-profit boards should also establish a policy and procedure addressing how to evaluate the performance of executive officers and staff members and should take the performance review into consideration in determining their compensation.

e. Restricted Contributions.

Frequently, a donor will make a contribution to a not-for-profit organization and place restrictions on how such funds may be used. For example, the donor may want to fund a specific initiative or activity of the not-for-profit organization. These are called restricted or designated funds. It is the board's responsibility to ensure these funds are used for the purpose the donor specified, and not for other expenses, such as overhead or other program activities. The directors should ask that any financial reports they receive specify whether the income is restricted or unrestricted, so that the directors can

ensure that the donor's wishes are being carried out.

Additional Resources

You may find the following information helpful in reviewing your organization's good governance practices:

- Redesigned Form 990, Schedules and Instructions http://www.irs.gov/charities
- Principles for Good Governance and Ethical Practice: A Guide for Charities and Foundations (October 2007) http://www.nonprofitpanel.org
- Guide to Nonprofit Corporate Governance in the Wake of Sarbanes-Oxley, ABA Coordinating Committee on Nonprofit Governance, American Bar Association (2005)

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