



Duty of a Nonprofit's Board of Directors to Oversee Financial Affairs

I. Need for Financial Oversight

Corporate governance has been an important issue on the national agenda since the 2002 enactment of the Sarbanes-Oxley Act, which dramatically improved the corporate governance standards for publicly-traded companies. While most reforms contained in Sarbanes-Oxley do not apply to nonprofit organizations, high-profile scandals involving nonprofit organizations have increased efforts to ferret out improper practices and encourage good organizational governance.

As part of this effort, IRS Form 990, the annual return filed by nonprofit organizations with annual gross receipts of \$200,000 or more, contains questions that require a nonprofit to disclose whether it has adopted the best practices contained in Sarbanes-Oxley. In particular, the form now contains several sections that focus on financial disclosure. For example, the form asks:

- Were the organization's financial statements reviewed by an independent auditor?
- Does the organization have a committee of the Board that is responsible for the selection of the independent auditor?
- Does the committee oversee the work of the independent auditor 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 extended corporate governance principles to nonprofit organizations. In addition, most donors, grant-makers and members now expect that nonprofit organizations follow these good governance principles and that nonprofit boards exercise stronger oversight over the financial affairs of the organizations.

II. Role of the Board

One of the main goals of nonprofit governance reform is to educate nonprofit boards about their proper role in overseeing the management of their organizations. This is because most high-profile nonprofit scandals involve nonprofit boards that have either acquiesced to or been unaware of certain financial improprieties, 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.

Nonprofit board members are often donors to the nonprofit or have family, business or organizational ties with the organization. Consequently, these board members may be less inclined to question the actions of the board or management.

The Form 990 addresses this issue by asking whether any board member has a family or business relationship with any other board member. Although such relationships are permitted, it is important that the relationships are disclosed, so that people are aware about how they can, impact Board member's judgment, even unconsciously.

Any board that includes members who have family, business or organizational ties with the nonprofit or each other must review its oversight practices to ensure that it can document that extra steps were taken to ensure that there was

impartial review and approval of its financial decisions.

In addition to the disclosure requirements contained in the Form 990, the IRS focuses on the size of the board and the role of independent directors. On the Form 990, nonprofit organizations must disclose the number of members of the governing body and the number of members that are independent.

a. Size of the Board

A nonprofit board should have an appropriate number of members to conduct effective oversight of the nonprofit. A board with too few members may not have sufficient resources to be effective, while on an overly large board, individual directors may have less sense of responsibility for overseeing financial affairs of the organization. Some nonprofit organizations have large boards in order to increase donations and fundraising. However, as recent scandals have shown, it is more desirable—and a sign of good practice—to have effective “working” boards.

b. Independent Directors

A nonprofit should focus not only on the board's size, but also on the number of independent directors on the board. The presence of independent directors is viewed as evidence that the board has the ability to make independent decisions that are in the best interests of

the organization, and that the board is not populated by insiders.

In a nonprofit organization, a director is considered independent if he or she, or a close family member, does not receive compensation from the organization, is not affiliated with management and has no personal interest in a specific transaction.

- See “[Independent Directors and Tax-Exempt Organizations](#)”

If a director has a personal interest in a transaction, that interest may have a direct influence on how the organization engages in such transaction. For example, there is a risk that if a director supplies goods or services to the nonprofit, he or she 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, it is a good governance practice to have independent directors on the board and to institute a conflict-of-interest policy so that directors with personal interests in specific transactions are excluded from decision making on those matters. In addition, the nonprofit should document the fairness of the decision-making process.

- See “[Conflict-of-Interest Policies: Disclosure, Monitoring, and Enforcement](#)”

For most nonprofit organizations, it is considered a good governance practice to have a majority of the board made up of independent directors. Independent directors are better situated to oversee the operation and management of the organization in an objective and unbiased manner and to make decisions that are in the organization’s best interests.

In any case, members of the board, whether or not they are independent, should understand and fulfill their obligation to objectively evaluate the information provided to the directors and make decisions in the organization’s best interests.

III. Financial Statements

It is essential for a nonprofit organization to have a complete and accurate financial statement that is prepared in accordance with generally accepted accounting principles. This allows the directors to fulfill their legal responsibility to exercise appropriate oversight of the organization’s financial resources. If an organization does not have a board member or volunteer with financial expertise, it should consider retaining a qualified accounting professional to prepare and review its financial statements.

Many nonprofit organizations do not have their financial statements audited

by an independent accountant. However, since the Form 990 asks whether an independent accountant compiled, reviewed or audited the organization's financial statements, most nonprofit organizations should consider having their financials audited by an independent accountant. Moreover, the charitable solicitation statutes of many states may require an organization to have an independent audit in order to solicit funds in that state.

In addition, a nonprofit organization with significant financial resources should have an audit committee composed solely of independent directors, whose function is to oversee the work of the organization's independent auditor, review the organization's 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.

- See "[Audit Committee and Audit Committee Charters](#)"

IV. The Board's Obligation to Ensure Sound Financial Management

One of the board of directors' most important responsibilities is to assure that the organization has sound financial management. 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 volunteers who have the necessary skills. However, the board should establish policies to assure that at least two people bear responsibility for receiving, depositing, and spending the organization's funds. The board is also responsible for reviewing practices and reports to ensure that staff members or volunteers are complying with board-approved policies.

The board should also receive regular monthly financial reports (or quarterly reports, in the case of smaller organizations). 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 should review and approve the organization's annual budget and should monitor actual expenses and revenue 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 maintain the financial stability of the organization.

c. Prudent Investment of Financial Assets

A nonprofit board has the obligation to establish policies and procedures to ensure that the organization manages and invests its funds responsibly in compliance with all legal requirements. In particular, a board of a nonprofit organization with 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. The boards of nonprofit organizations with sizeable reserves should select one or more independent investment managers to handle the organization's investment, to be monitored regularly by the board or a committee of the board.

d. Expenses and Compensation

Boards of nonprofit 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, nonprofits should not pay for travel expenses incurred by spouses or others who are accompanying someone conducting business on behalf of the organizations. In addition, it is a best practice to have independent directors who are not affiliated with management determine the compensation of executive officers and ensure the compensation decisions are tied to the job performances.

- See [“Nonprofit Executive Compensation”](#)

Nonprofit boards should also establish a policy addressing how to evaluate the performance of executive officers and should take the performance review into consideration in determining their compensation.

e. Restricted Contributions

Frequently, a donor will make a contribution to a nonprofit organization and place restrictions on how the funds may be used—for example, to fund a specific initiative or activity of the nonprofit organization. Such donations 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:

- IRS, Form 990, Schedules and Instructions
<https://www.irs.gov/charities-non-profits/annual-reporting-and-filing>
- Principles for Good Governance and Ethical Practice: A Guide for Charities and Foundations (2015)
<https://www.independentsector.org/wp-content/uploads/2016/11/Principles2015-Web-1.pdf>
- D.C. Bar Pro Bono Center, The Role of the Board of Directors in Financial Oversight: A Guide for Board Members
<http://www.lawhelp.org/files/7C92C43F-9283-A7E0-5931-E57134E903FB/attachments/4EFA05DA-0B76-4478-AC04-06AEDE61C6E7/financial-oversight-manual-october-2015-update.pdf>

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