

THE CHANGING RULES FOR NONPROFIT GOVERNANCE:

BEST PRACTICES OF SARBANES-OXLEY

As discussed
October 13, 2004
Manchester, NH

Presented by:

DEVINE
MILLIMET
ATTORNEYS AT LAW

BERRY.DUNN.MCNEIL & PARKER
BDMP
CERTIFIED PUBLIC ACCOUNTANTS
MANAGEMENT CONSULTANTS

Moderated by:

Lewis M. Feldstein, President
New Hampshire Charitable Foundation

The Rules for Nonprofit Governance Are Changing: Are You Ready?

Today's nonprofits are faced with a changing governance environment that brings with it a need to examine current board practices and consider new ones. These changes in expectations for nonprofit boards have been prompted in part by the Sarbanes-Oxley Act of 2002, a federal law concerning corporate governance that was passed in response to a host of corporate financial scandals. While Sarbanes-Oxley's provisions apply to for-profit companies whose stock is publicly traded, the law's governance provisions have generated discussion, proposed regulation, and introduced new practices in the nonprofit world.

The evolving changes in today's governance best practices - and the way nonprofits should respond - formed the theme of a breakfast roundtable discussion focusing on nonprofit governance held October 13th, 2004 in Manchester, New Hampshire. This event was co-sponsored by Devine Millimet & Branch, P.A. and Berry, Dunn, McNeil & Parker. Lewis M. Feldstein, president of the New Hampshire Charitable Foundation, served as moderator and facilitator of the discussion. Jon B. Sparkman, a corporate attorney who is a shareholder of Devine Millimet, and Erick L. Worden, a CPA who is a principal of Berry, Dunn, McNeil & Parker presented on the topic.

Lewis M. Feldstein: A Charitable Foundation Executive's Perspective

Lew Feldstein opened the roundtable discussion by explaining that Sarbanes-Oxley isn't the only factor driving change in nonprofit governance. In addition, he said, there are other changes under consideration at the state and federal levels, all of which point toward increasing regulation of the nonprofit sector. Feldstein said that changes in state legislation governing nonprofits have been proposed and, in some cases, enacted in California, Massachusetts, Illinois, New York and Mississippi.

He also noted that most legislators would like to see the nonprofit sector do more self-policing. In New Hampshire, Feldstein referenced, there is an informal working group that the New Hampshire Charitable Foundation (NHCF) and the New Hampshire Attorney General's Office have convened to look at issues of nonprofit governance. That working group has launched a series of six "Conversations on Excellence in Nonprofit Governance" that are being held around the state in October and November. One aim of the working group, according to Feldstein, is to improve governance in the New Hampshire nonprofit community, underscore the state's already exemplary record in setting high standards for nonprofit governance, and thereby reduce the likelihood of added regulation of the sector. The working group, he said, will be proposing three initiatives and areas for discussion:

- Raise awareness of the current laws impacting the nonprofit sector;
- Consider the concept of a simple ‘governance checklist’ that all New Hampshire charitable organizations would be asked to fill out when applying for funding from participating private funders, including family, corporate foundations, health conversion foundations, community foundations, and United Ways. The checklist, Feldstein said, would reflect requirements already present under existing state law. Completing it would be voluntary – however, he added, failing to complete the checklist would make one ineligible for funding from participating funders; and
- Consider creating a voluntary set of best practices for nonprofit governance, and developing a way for nonprofits to qualify as excellent in governance.

The checklist would go into effect in 2005. The best practices would take longer for the sector to build and implement. Feldstein added that the aim is to undertake these initiatives in a way that won't leave smaller nonprofits feeling burdened.

Jon B. Sparkman: A Legal Perspective

Jon Sparkman, a corporate attorney and shareholder with Devine Millimet whose practice includes work with nonprofit organizations, discussed some of the key legal issues relevant to nonprofit governance. Sparkman observed that public trust and confidence in New Hampshire's charitable organizations and nonprofits is critical to accomplishing their missions. However, Sparkman added, nonprofits have several areas of vulnerability, including the fact that they have no shareholders. Without shareholders, there's a missing piece of accountability in the nonprofit world that is built into the for-profit world. Sparkman said that the lack of accountability to shareholders means that nonprofit boards and executive directors must play a watchdog role if the nonprofit sector is to avoid increased regulation. Nonprofits are also vulnerable to attention from the IRS on various issues, including compensation, as well as to action by state legislators and regulators.

Sparkman noted that individual directors of nonprofits also have a vulnerability to liability concerns. Directors on boards have duties to the organization, including a "duty of care" - they must care about the organization and its operations - and a "duty of loyalty" - they must act in the best interests of the organization. "Those are real duties," Sparkman observed, "and with real duties comes real liability." Although nonprofit volunteers (including volunteers who serve as directors) in New Hampshire have some statutory protection for certain liabilities as long as they act in good faith, without negligence and in the best interests of the organizations, directors still might get sued.

Sparkman continued to state that, in general, directors are protected by what is called the "business judgment" rule, which gives board members some liability protection if they act in the interests of the organization and in accordance with their best business judgment – even if their judgment is later proven to be wrong. Further liability protection can come from directors and officers (D&O) insurance policies and/or from indemnification by the nonprofit organization.

On the topic of nonprofit executive compensation, Sparkman said the primary place to look for guidance is the IRS's rules on what are known as "intermediate sanctions." The IRS requires that executive compensation decisions at nonprofits include a comparison using salary data from other organizations, and the compensation decision needs to be reviewed and decided during a meeting of the board or its executive committee "in the light of day" and with the executive not in the room.

Sparkman also alluded to New Hampshire's statutory conflicts of interest policy requirement, which covers potential conflicts of interest among nonprofit board directors. Under this groundbreaking legislation, passed in 1996, Sparkman said that New Hampshire charitable organizations are required to have a conflict-of-interest policy. Under the law, a New Hampshire nonprofit may not enter into a transaction with a board member or officer unless:

- The transaction is fair to the charity and in its best interests;
- There is full and fair disclosure of all the relevant factors;
- The person involved does not participate in the board's discussion and vote on the topic -- this includes having the person leave the room; and
- The transaction has to be documented in the Board's minutes, and, if the transaction is for \$5,000 or more, notice must be published in a local newspaper and be delivered to the New Hampshire director of charitable trusts.

Sparkman added that there are other governance topics New Hampshire nonprofit boards should examine. For example, an organization's bylaws may need to be updated to reflect changes in board procedures, such as a specification that the board have an audit committee. He also recommended that boards consider the question of term limits for directors and be aware that the tone of board meetings should, ideally, encourage "healthy debate." But, having good governance policies in place is not enough – the nonprofit must put the policies into practice. For example, Boards, Sparkman said, should have an orientation for all new directors, and the orientation should include information about governance and bylaws, as well as about the organization's mission and finances.

Erick L. Worden: An Accounting Perspective

Erick Worden, a CPA who is a member of Berry, Dunn, McNeil & Parker's Not-For-Profit and Higher Education Industry Groups and the head of the Manchester Office, noted that many nonprofits, including education and health organizations that operate in highly regulated industries are turning to best practice recommendations relating to Sarbanes-Oxley. Although there are no shareholders in nonprofits, there are plenty of stakeholders, including donors, employees, the board of directors, the IRS, and the media. "All those parties are interested in accountability in the way the organization's resources are managed," Worden explained.

Worden noted that some provisions of Sarbanes-Oxley make sense for nonprofit organizations, too. Different industry groups and associations are providing information to their members concerning applicable provisions and best practices. He referenced a checklist for higher education institutions put together by the National Association of College and University Business Officers (NACUBO); this checklist describes provisions of Sarbanes-Oxley relevant to higher education institutions. NACUBO uses this to help higher education institutions determine whether, and to what extent, they should implement those provisions. In general, Worden suggested, those involved in nonprofit governance should look at Sarbanes-Oxley's standards and evaluate what makes sense for their organizations and what is cost-effective.

One area of focus for Sarbanes-Oxley that may be relevant to nonprofits, according to Worden, is the question of audit committees, audits, and auditor independence. According to Sarbanes-Oxley, there are certain non-audit services that should not be provided by your existing financial auditors such as bookkeeping or actuarial services. He suggested that boards should consider establishing a separate audit committee or, if they assign audit functions to a finance committee, change the committee's name to "Finance and Audit." Worden said that the audit committee, rather than the nonprofit's management, should take responsibility for overseeing the annual financial audit. He explained that, under Sarbanes-Oxley, audit committees at publicly traded for-profit companies are required to include at least one member who is a financial expert. That person need not be a CPA, he said, but should be conversant in financial statements and understand the nature of sound financial management in general. While it can be difficult to find financial experts to serve voluntarily on a nonprofit board, the idea of having a financial expert on a nonprofit board's audit committee is a good recommendation. Some of the duties of the committee would include:

- Monitor changes between actual, budgeted and prior year's results
- Oversee annual audit process
- Hold direct responsibility for hiring and overseeing the outside auditor
- Assess operating risks periodically (e.g. is there a disaster recovery plan in place?)

Worden pointed out that larger nonprofit organizations may need three financial experts on the board: one as treasurer, one on the audit committee, and one on the investment committee.

Additionally, Worden noted that there are other key topics covered under Sarbanes-Oxley that nonprofits should examine including:

- Formalizing an ethics policy for senior managers
- Requiring an organization's CEO and CFO to certify that its financial statements have no material misstatements or omissions
- Instituting "whistleblower" provisions to receive and deal with complaints and to protect those who report possible accounting or internal control problems.

CLOSING DISCUSSION

After the legal and accounting angles were discussed, Feldstein asked the nonprofit participants in the room to consider various governance questions, and lively discussions ensued. The two main areas of roundtable discussion focused on:

- "Duty of loyalty" to an organization relative to the board member who offers a product or service to the organization at what seems like a reasonable price. Approaches and real-life experience for managing those kind of problems and conflicts were discussed at some length; and
- Executive compensation decisions: boards should document in their minutes that they used comparative salary data in setting the compensation. Feldstein also raised the question of whether nonprofits should include their executives' compensation in their annual reports. The discussion on this topic was very lively with strong feelings expressed by the participants both for and against disclosure.

In closing, Feldstein acknowledged that the changing governance standards are tough and that the answers are not cut-and-dry. He suggested that nonprofits need to adapt new governance ideas to their organizations, cultures and practices. Overall, in the New Hampshire nonprofit community, "We're moving into new territory," Feldstein concluded. "The expectations on us have gone up, and we can learn from the practices of our peers."

R O U N D T A B L E E X P E R T S

Lewis M. Feldstein
President, New Hampshire Charitable Foundation
603.225.6641 / lf@nhcf.org

As President of the New Hampshire Charitable Foundation (NHCF), a statewide community foundation and the principal source of venture capital for New Hampshire's nonprofit community, Lew is actively involved in the nonprofit sector. NHCF finished 2003 with \$288.2 million in assets, received \$52.2 million in gifts, and distributed \$17 million in grants and scholarships. Lew was selected as one of the 100 people Who Shaped New Hampshire in the 20th Century, published by the Concord Monitor, and one of the ten most influential people in New Hampshire by Business NH Magazine in 2001.

Jon B. Sparkman, Esquire, CPA
Shareholder, Devine, Millimet & Branch, P.A.
603.695.8507 / jsparkman@devinemillimet.com

Jon has built an active business law practice serving privately held companies and nonprofit organizations. He has worked with a number of clients regarding formation, obtaining and maintaining tax-exempt status and a wide variety of governance issues. Specific tax-exempt issues include avoidance of intermediate sanctions and compensation planning. In addition, Jon has combined his business and tax experience in representing investors in affordable housing projects including low-income housing tax credit projects, historic tax credit projects, senior assisted living projects and projects for working families.

Erick L. Worden, CPA
Principal, Berry, Dunn, McNeil & Parker
603.669.7337 / eworden@bdmp.com

Erick is a member of the Firm's Not-for-Profit and Higher Education Industry Groups. Erick specializes in providing a full spectrum of audit, tax and management consulting to his clients. He has significant experience in issues important to colleges and not-for-profit organizations including capital campaigns and restricted gifts, UMIFA, endowments, split-interest agreements and OMB Circular A-133. Erick is the head of the General Practice Group of Berry, Dunn, McNeil & Parker's Manchester office and serves on the Firm's Management Committee. Erick is certified in Maine and New Hampshire and is a member of the AICPA. He is actively involved with the Small Business Association of New England and other professional service organizations. He began his accounting career in San Diego, California after graduating from Salem State College.