

Best Practices in Nonprofit Governance: Doing it Right without Drowning

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by
Lisa Norton
*Law Office of Lisa Norton PLLC***

I. Introduction

What is Governance?

Governance refers to the organizational documents, management structure, and operational and administrative policies that help ensure that an organization is operated consistently with its purposes and in compliance with applicable laws.

Why should organizations care about governance?

Demonstrate sound stewardship of resources. The IRS, funders and others are increasingly focusing on good governance practices as an indicator that an organization is operated effectively and efficiently in furtherance of its mission.

In 2005, a panel of distinguished representatives from the nonprofit sector, convened by Independent Sector, issued its Report to Congress and the Nonprofit Sector, “Strengthening Transparency, Governance and Accountability of Charitable Organizations.” Many of the report’s recommendations are reflected in the new IRS Form 990 reporting requirements, for fiscal years beginning in 2008 and thereafter.

Retain 501(c)(3) status. Governance policies help ensure that an organization does not act in ways that could jeopardize its 501(c)(3) status. For example, conflict of interest policies and procedures help to prevent the use of an organization’s resources for any private benefit that is inconsistent with the mission. Compensation policies help to avoid misappropriation of funds through payment of excess compensation or fringe benefits.

New Form 990 governance disclosures. The new Form 990 (for fiscal years beginning in 2008 and beyond) requires disclosure of the existence of a number of governance policies.

- **IRS audit risk.** While most of these policies are not tax law requirements, a failure to check “yes” on the Form 990 could be an IRS audit trigger.

- **Funders and other constituents.** Form 990 is readily accessed by the public, for example through www.guidestar.org or www.eri-nonprofit-salaries.com. Be mindful that potential funders, and others with an interest in your organization for a variety of reasons, will be able to gain a lot of information about your governance practices.

Smaller organizations filing Form 990-EZ. 501(c)(3) organizations may use the simpler Form 990-EZ in lieu of the Form 990 if gross receipts and assets meet both of the following thresholds:

Tax Year Beginning in	Gross Receipts Less Than	Assets Less Than
2008	\$ 1 million	\$ 2.5 million
2009	\$ 500,000	\$ 1.25 million
2010 and beyond	\$ 200,000	\$ 500,000

The new Form 990, some high-profile instances of abuse, and the Independent Sector Nonprofit Panel Report, are all contributing to a growing consensus that good governance practices are an important factor in assessing an organization. Even those organizations not required to file Form 990 will likely find that funders and other constituents, like the IRS, expect that an organization practices good governance.

The IRS Commissioner noted in a 2008 speech to Independent Sector, “Even small nonprofit boards have begun to put a high priority on having strong financial controls, good governance, and management accountability.”

Governance practices not disclosed on Form 990. The Form 990 does not address every aspect of good governance that may be considered important by funders and other constituents. Additional policies and procedures may be required under other applicable laws or by licensing agencies or funders, or may be advisable given the nature of the organization’s activities.

Think of good governance practices as an opportunity. By adopting and following good governance policies and procedures, an organization demonstrates to its constituents that it is dedicated to devoting resources effectively in pursuit of the mission.

Think of the Form 990, or 990-EZ, as not merely a tax filing, but also as promotional material. This may be the primary way some constituents learn about your organization. Give careful thought to the descriptions of significant activities and accomplishments, and of governance procedures.

II. What policies does your organization need?

New Form 990 disclosures. The following policies, disclosed on the new Form 990, are increasingly considered governance best practices, even for those organizations that do not file Form 990.

Policies Required to be Disclosed	Is description of procedure required?
1. Conflict of Interest/ Ethics Policy <ul style="list-style-type: none"> • Annual disclosure of conflicts by officers, directors or trustees and key employees 	Yes; describe procedure for regular and consistent monitoring and enforcement
2. Compensation Policy (Chief Executive and key employees)	Yes
3. Document Retention and Destruction Policy	No
4. Whistleblower Policy	No
5. Contemporaneous documentation of board and board committee meetings and actions	Yes
6. Public disclosure: Forms 1023 and 990, governing documents, conflict of interest policy, financial statements	Yes
7. Audit Committee, if audited by independent auditor	No
8. Board Review of Form 990 (also required under WA law)	Yes
9. Joint Venture Policy, if applicable	No
10. Gift Acceptance Policy, for certain hard-to-value noncash gifts, if applicable	No
11. Grantmaking policy, domestic/ foreign, if applicable	Yes
12. Conservation Easements, if applicable	No
13. Chapters, if applicable	No

Good governance policies not disclosed on Form 990

Organizations should consider adopting the following additional policies to help ensure sound stewardship over assets:

1. Gift Acceptance Policy (general)
2. Investment and Spending Policy
3. Expense reimbursement (990 requires disclosure for limited items)

Additional policies may be required or advisable, depending on the nature of the organization and its particular activities.

Policies should be tailored to the organization. Policies may be more or less detailed, and the degree of complexity should be tailored to fit the size and nature of the organization. Above all, be sure that the organization is able to comply with the terms of any policies and procedures it adopts. It's better to have simple procedures that you can comply with than complex procedures that are ignored.

Adopt appropriate procedures to ensure compliance. Policies are meaningless without internal procedures to ensure compliance. Form 990 filers are required to describe procedures related to a number of the disclosed policies (See Table above).

Make sure the board and management are informed. Every organization should have a board orientation package that includes all of the governance policies.

III. Heightened Focus on Board of Directors

Board Composition. The IRS and Independent Sector Nonprofit Panel Report focus attention on the size and composition of boards of directors.

Number of Directors

Organizations should assess and determine the optimum board size in light of the organization's size, resources, nature and scope of activities. There is no one size fits all.

Washington's Nonprofit Corporation Act permits a minimum of one director. The 2005 Independent Sector Nonprofit Panel report recommends a minimum of five directors, and some nonprofit liability insurers have required a minimum of five. In many organizations, some or all officer positions are filled by directors rather than paid staff. Under Washington Law, the offices of President, Vice President, Secretary and Treasurer must be held by at least two separate individuals, with separate individuals holding the offices of President and Secretary.

Independent Directors

Independent directors are important to ensuring that the board provides independent, objective oversight and avoids conflicts of interest.

In general, to be independent, a director must not receive (nor may his or her family members receive) compensation as employees, officers or independent contractors, nor receive loans or other benefits from the organization. The IRS definition of independence is more technical.

Organizations filing Form 990 will have to disclose the number of directors that meet the IRS definition of independence. All organizations, whether or not filing Form 990, should carefully consider the value of having independent directors, and consider adopting by-law provisions requiring that a significant (possibly a majority) portion of the board is independent.

Board Diversity

Board diversity is increasingly a focus of funders and other constituents. Diversity can take any of several forms, and each organization is well advised to consider what is appropriate given the organization's mission, activities and constituents. Above all, an organization should be intentional about recruiting board members with a variety of skills and backgrounds as appropriate to the organization.

Community representation. Many organizations strive to include board members with backgrounds that reflect the breadth of the constituents served. Community representation can also in some cases be important or helpful in maintaining an organization's status as a public charity.

Expertise. Consider recruiting board members who have expertise in critical areas, such as finance. The nature of an organization may also be such that certain professional backgrounds (e.g., health care or education) are desired.

Because financial oversight is a critical component of good governance, it is important that at least one board member have financial literacy. The degree of financial sophistication required will vary depending on the size and nature of the organization. Board that have trouble recruiting members with financial expertise may consider appointing one or more non-board members to finance and audit committees, if permitted by the by-laws.

Board Procedures

Fiduciary duty. Under Washington law, directors have the following duties:

- To act in good faith,
- To act in the best interests of the organization, and

- To act with reasonable care, making reasonable inquiries.

Committee structure. There is no one-size fits-all to committee structure. However, many organizations find that good governance is served by having committees (of at least two directors, and possibly non-directors) focused on:

- Finance
- Audit
- Board nominating/ recruiting
- Compensation

Delegating to committees. A board may delegate authority over certain matters to a committee (with some exceptions). A frequent example is delegation of responsibility for reviewing financial matters to a finance committee that has special expertise. Caution is advised, however. Board members cannot relinquish their fiduciary responsibility, and should be aware of their obligation to be informed, and make appropriate inquiry, on matters of importance.

Frequently, a committee (such as finance or audit) is given primary authority for reviewing the budget, audit and Form 990 or 990 EZ, and for making a recommendation of approval to the full board.

Board and Committee Minutes

Maintaining a record of actions taken by a board and board committees is a critical aspect of governance. Under Washington law, a director who was present at a meeting is assumed to have assented to any action, unless the minutes reflect otherwise.

The new Form 990 requires disclosure of whether contemporaneous minutes are prepared for board actions and those of any committee with broad authority.

How much documentation is appropriate? At a minimum, minutes should set forth:

- who was present
- actions taken
- who dissented
- any conflicts of interest that were disclosed to the board, and how they were dealt with

When important matters are addressed, consider documenting the significant issues that were discussed, thereby establishing that the board exercised due diligence and providing some institutional memory. Beware of over-documenting. Boards and directors have at times found themselves in trouble over comments made in the course of a discussion that found their way into formal minutes.

IV. Oversight of Financial Matters

A critical aspect of governance is oversight of the budget and financial processes. Washington State's Charitable Solicitations Act requires that the full board or a committee thereof reviews all financial reports required to be provided to the Secretary of State. These include the annual Form 990 or 990-EZ, and certain financial information

Board Finance Committee

Most boards (other than very small boards) should have a finance committee that includes at least one member with financial expertise. The degree of expertise required will vary according to the size and nature of the organization. A non-board member may serve in this capacity if the by-laws permit.

Internal Controls

No single person should have control over receiving, depositing and spending of funds. Volunteers, appropriately trained and vetted, can provide oversight in the absence of sufficient staff. All organizations should have formalized processes, appropriate to the size and nature of the organization, for the handling of funds.

Audit Committee

Audited financial statements provide funders, potential funders and other constituents with a higher degree of confidence in the integrity of an organization's financial management. Many organizations find that funding foundations require audited financial statements.

For those organizations that have audited financial statements, it is widely considered a best practice to have a board audit committee overseeing the audit to ensure the independence of the auditors. The new Form 990 requires disclosure of whether an audit committee exists.

The audit committee should be responsible for selecting the auditors, monitoring their independence from management and reviewing the audit. Non-board members can be recruited to serve on an audit committee, if by-laws permit.

Even organizations that do not undergo independent audits are well advised to have an independent accountant review annual financial statements.

Board Review of Form 990

Good governance practice. The Form 990, or 990-EZ, is a tax compliance document, but also a public document which discloses a lot of information about an organization. In fact, for some constituents it may be the primary way of learning about an

organization. For these reasons, it is critical that board members receive the 990 or 990-EZ and understand the information provided.

Promotional opportunity. Management and boards should also think of the Form 990 (or 990-EZ) as an opportunity to promote the mission and accomplishments of the organization.

Review requirements and disclosure. The new Form 990 asks whether the form has been provided to each member of an organization's governing body, in its final form, *prior to filing*. Washington state law requires that the 990 be reviewed by the board or a committee thereof.

Timing of the Form 990 review. An emerging best practice is to have the Form 990 reviewed by the audit committee. In the absence of an audit committee, the finance committee should perform the review. The full board should then receive copies of the completed form in advance of filing. If the timing of board meetings may not allow for full board review during a meeting (as will often be the case), the full board can be provided copies by mail.

Review of 990-EZ. The 990-EZ does not ask about board review, but Washington State organizations that file the 990-EZ are still subject to the Washington law requirement that the board or committee review the 990-EZ.

Endowment, Investment and Spending Policies

Another critical aspect of governance is oversight over the preservation and use of assets in furtherance of the mission. Boards have a responsibility to oversee investment policies and management of investments (whether investment management is directly performed by outside managers, staff or board members). A board may hire and rely on the advice of an outside investment manager, but still has a responsibility to monitor the manager's performance.

The investment and spending of endowment funds should always be governed by a written policy. In addition, it is advisable to have written policies addressing investment objectives and spending authority for non-endowment funds.

Expense Reimbursement

All organizations that reimburse employees, officers and/or board members for travel and other business expenses should have a written expense reimbursement policy. The policy need not be very long or complex, but should be clear as to which expenses are reimbursable and must require documentation of the purpose and amount as a condition to reimbursement.

Public Disclosure of Documents

Federal tax law requires public disclosure of a 501(c)(3) organization's application for tax exempt status (Form 1023 and attachments), Form 990 or 990-EZ (excluding the list of contributors), and 990-T (unrelated business income, if filed) for the past three years. Disclosure may be through the organization's website.

In addition, it is becoming increasingly common practice for organizations to post annual statements, financial statements, and in some cases conflict of interest policies on their websites.

V. Avoiding Conflicts (and perceived conflicts) of Interest

Avoiding conflicts of interest, and perceived conflicts of interest, is critical to avoiding unethical or illegal practices, and thus to maintaining the trust of funders and other constituents, as well as to maintaining tax-exempt status.

Conflicts may arise out of:

- **Business transactions.** Business transactions between a nonprofit corporation and its officers or directors (or their family members) may give rise to conflicts, or the appearance of conflicts. Such transactions are not necessarily improper, but must be disclosed and approved by disinterested directors.
- **Other benefits provided.** Benefits, such as scholarships, when provided to individual directors, officers or key employees, or members of their families, may also give rise to the appearance of impropriety. While it may be appropriate to provide such benefits to individuals who are members of a charitable class to whom benefits are provided, great care must be exercised.
- **Loans.** Loans to officers or directors of a Washington nonprofit corporation are prohibited

It is important to note that an organization need not avoid involvement in all transactions or grants where a board member, key employee or officer has a conflict. Rather, the critical point is that disinterested board members must approve such a transaction with full knowledge of the conflict. Board minutes should document the disclosure of a conflict, the interested member's abstention from voting, and approval by disinterested board members. In this way, the board can demonstrate that it is at all times acting in the best interests of the organization, in accordance with its fiduciary duty.

Conflict of Interest Policy

The existence of a written conflict of interest policy is widely viewed as highly important to good governance.

A conflict of interest policy need not be complex. In its most basic form, the policy requires disclosure of any conflicts, and further requires that a board member abstain from voting on any matter in which the member has a conflict. The IRS provides a basic form of policy in the instructions to Form 1023 (Application for Recognition of Exemption Under Section 501(c)(3)). See. www.irs.gov. Any conflict of interest policy, like all policies, should be tailored to the nature and size of the organization.

Annual Survey of Directors, Officers and Key Employees

Organizations should have officers, directors and key employees sign a conflict of interest policy upon joining the organization, and annually thereafter. This is usually done at the beginning of an organization's fiscal year.

In addition, organizations should consider using an annual questionnaire for reporting specific business relationships that give rise to conflicts or potential conflicts.

IRS Reporting

Form 990 Filers are required to disclose:

- whether the organization has a conflict of interest policy,
- whether annual disclosure of potential conflicts is required of officer, directors and key employees, and
- a description of the organization's procedures for monitoring and enforcing its conflicts of interest policy.

Some Form 990 and 990-EZ Filers are also required to file a schedule disclosing:

- certain business transactions, benefits and loans between the organization, or its affiliates, and any directors, officers, and key employees (current and former).

This is an area where some complexity is inevitable. Reportable transactions, loans and benefits include not only those directly involving officers, directors and key employees, but also their family members and other entities in which they are employed or hold certain specified ownership interests. All organizations required to file Form 990 or 990 EZ should designate a staff person or volunteer to be familiar with the requirements of Schedule L, "Transactions with Interested Persons."

Annual Survey of Directors, Officers and Key Employees

Organizations should have officers, directors and key employees sign a conflict of interest policy upon joining the organization, and annually thereafter. This is usually done at the beginning of an organization's fiscal year.

In addition, organizations should consider using an annual questionnaire for reporting of specific business relationships that give rise to conflicts or potential conflicts.

VI. Managing Contributions

Donor Acknowledgement

All 501(c)(3) organizations must have procedures regarding acknowledgement of contributions, to comply with federal tax law requirements as well as to maintain good relationships with donors.

Federal tax law requires that 501(c)(3) organizations provide the following written statements to donors:

- written acknowledgement, stating amount, of cash gifts of \$ 250 or more; description of any property;
- fundraising events: a statement of value received by any contributor in exchange for any payment (such as the value of a meal included in price of admission), subject to certain exceptions for low-value items, .

Additional statements to donors and/ or filings may be required in specific situations.

Beyond any applicable legal requirements, acknowledging donor contributions and keeping donors informed of an organization's activities helps to build loyalty and confidence among constituents.

Gift Acceptance Policy

Every 501(c)(3) organization that accepts contributions from the general public should consider adopting a gift acceptance addressing:

- **Restricted gifts.** What kinds of restrictions will the organization accept and/ or what procedures will be followed to determine whether a restricted gift will be accepted?
- **Non-cash gifts.** What kinds of non-cash gifts will be accepted, and/or what procedures will be followed in determining whether a gift will be accepted? Will non-cash items be accepted only for use in performing the organization's exempt function, or will the organization accept certain non-cash items for sale?

For many organizations these procedures will be very simple. Organizations that accept noncash contributions may need more complex procedures to ensure compliance with applicable tax reporting requirements.

Form 990

The Form 990 (but not 990-EZ) requires reporting of procedures regarding acceptance of certain types of noncash contributions that are difficult to value. Form 990 filers must report all noncash contributions if total noncash contributions exceed \$ 25,000, or if certain types of noncash contributions were received.

Compliance with Donor Restrictions

Organizations that accept contributions restricted in time or purpose should have procedures to ensure that the funds are used in accordance with donor restrictions, and that the use of those funds is tracked. It is common to pool restricted (non-endowment) funds for investment purposes, while separately tracking them.

Control Over Contributed Funds or Assets

Contributed funds or assets must be under the control of the organization. Even in the case of restricted gifts, the organization must have discretion and control such that it can ensure that the funds are used for tax-exempt (501(c)(3) purposes. It is critical that donors are advised of the extent of the organization's control.

VII. Executive Compensation

The IRS, funders and other constituents are interested in knowing that compensation paid to executives is reasonable in amount. Excessive compensation paid to key employees, officers or directors can trigger tax penalties. In addition, some highly publicized instances of excessive compensation and fringe benefits paid by large 501(c)(3) organizations have focused public attention on this area.

All organizations should adopt procedures to document that salaries and benefits paid to key employees, and directors and officers if applicable, are reasonable in amount (consistent with market rates). These procedures need not necessarily be complex, but should be appropriate to the size and nature of the organization.

Written employment contracts. Organizations should have written employment contracts for all employees.

Employment policies. Organizations should have written employment policies appropriate to the size and nature of the organization.

Reasonable compensation: IRS rebuttable presumption. IRS regulations provide a procedure for organizations to follow in setting compensation for the top employee, and other key employees and officers as applicable. Organizations should consider adopting these procedures to help protect against any IRS challenge, and to assure constituents

that the board is acting prudently in setting compensation. When these procedures are followed, the IRS will presume the compensation to be reasonable (not excessive), although the IRS does retain power to challenge.

The IRS procedure requires:

- a review of compensation data from comparable organizations,
- approval of compensation and benefits by disinterested board members (or board committee), and
- contemporaneous documentation of the process.

The amount of data to be obtained, and the number of employees included in the process, will vary with the size and nature of the organization, and complexity of compensation arrangements. Under the IRS rules, smaller organizations with less than \$ 1 million in annual revenue may rely on comparability data from as few as three other organizations.

Form 990 Disclosure

Organizations filing Form 990 (but not 990-EZ) are required to disclose the process for determining compensation of the top employee, key employees and officers, and specifically whether that process includes a review by independent persons, comparability data and contemporaneous documentation of the decision.

Some Form 990 filers will be required to complete an additional schedule disclosing further details about compensation, benefits and procedures.

APPENDIX

Links to Sources on Best Practices in Nonprofit Governance

1. Independent Sector Nonprofit Panel Final Report
http://www.nonprofitpanel.org/Report/final/Panel_Final_Report.pdf
2. Internal Revenue Service
www.irs.gov
3. BoardSource
www.boardsource.org
4. Urban Institute: Nonprofit Governance in the United States
http://www.urban.org/UploadedPDF/411479_Nonprofit_Governance.pdf

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