

NOT-FOR-PROFIT ORGANIZATIONS

PROPOSED LEGISLATION: ITS IMPACT ON NOT-FOR-PROFIT BOARD GOVERNANCE

By Stanley Weiner

The not-for-profit sector is the third largest of the U.S. economy, surpassing banking, technology, and even federal government spending. This sector directly contributes \$785 billion annually to the economy and employs one out of 12 Americans. The addition of \$81 billion of indirect transportation, meals, child care, and other costs increases the sector's contribution to \$866 billion annually.

New York State currently has approximately 46,000 registered charities. The New York State Bureau of Charities estimates that there could be just as many not-for-profits that are not registered. The assets controlled by these entities are significant and their cash flow is enormous, yet this area of the economy is largely unregulated.

Financial Mismanagement and Fraud

There are numerous examples of financial mismanagement and fraud in the not-for-profit sector, including misappropriation of funds, undue reliance on lines of credit, lack of timely and accurate financial reporting, and inappropriate compensation packages. The consequences of such misdeeds, for both the organization and the community it serves, can be severe. In the worst case, the collapse of a not-for-profit organization means loss of a vital service that the recipients cannot replace.

Example. A not-for-profit's interim financial reporting was over 90 days late. When the board reviewed an aging of the accounts receivable, management indicated that the late receivables were collectable. When pressed to collect the outstanding receivables, however, management found that certain invoices on contracts had been billed twice. In addition, other receivables were so old that the contract year had passed, making collection extremely difficult. The organization wrote off receivables in excess of \$350,000. The cash shortage created the forced paydown of its line of credit and difficulties with funding sources on existing and future contracts. If the organi-

zation had had accurate and timely financial information, its board might have been able to govern more effectively and management might have intervened more effectively.

Proper Financial Management

Several steps can be taken to prevent or mitigate the impact of financial mismanagement. The first and foremost is finding qualified staff. Most chief executives in not-for-profits are program experts, very conversant with operations but at a loss when it comes to finance. Attracting qualified accountants and financial managers is extremely difficult, as they tend to gravitate to the for-profit sector.

Attracting qualified board members could also pose problems. Board members, besides having an interest in the services the not-for-profit provides, should contribute skills in one or more of three major areas:

- General skills that further the organization's mission;
- Financial skills to assist the board in monitoring financial operations and in making key decisions; and
- Fundraising skills to assist in successful funds solicitation.

Unfortunately, attracting board members that fulfill the above criteria is as hard as finding qualified staff. Volunteer board members frequently are not qualified to deal with tough governance and management issues in their volunteer activities.

Developing accurate and timely financial information is another major hurdle.

When bad decisions are made as a result of insufficient or inaccurate information, the organization can find itself in unexpected trouble.

Without a skilled board equipped with timely financial information, an organization's ability to guard against fraud is limited. An atmosphere of extraordinary trust usually exists between the management and the board of a not-for-profit. These organizations generally rely on a mix of paid and volunteer personnel, and volunteers are often not qualified or motivated to safeguard the entity's assets. In the absence of financial expertise, the organization has limited supervisory or analytical resources to determine if fraud or financial mismanagement exists.

Proposed New York State Legislation

The New York State Attorney General has recently proposed legislation to increase accountability and improve internal financial controls within the not-for-profit sector (see the *Sidebar*).

Concerns Regarding Impact

While the need for improved financial management and control is generally recognized by some within the not-for-profit sector, there are significant concerns about recently proposed legislation. The threshold of \$250,000 for the requirements outlined within the proposed legislation is too low. Many entities of this size simply do not have the resources to both run

ASSESSING ADEQUACY OF INTERNAL CONTROLS

Officers certifying financial statements' accuracy and fairness, and the effectiveness of the organization's internal controls, will require assurance from management and other personnel of internal systems' and financial reporting quality. Internal control relates not only to financial areas, but also to asset protection, business continuity and contingency planning, and other areas related to the organization's vital interests. Officers should expect signoffs from all personnel related to internal control as to the accuracy of the financial report before they provide their certification. While such signoffs may be easy to acquire, they must be effective for officers to rely on them.

For larger not-for-profits, new automated systems will assist officers in evaluating internal control effectiveness. The systems monitor specific elements based upon self-audit tests and self-assessment. They are quantitative, can drill down to the specific account level, and can be audited by external accountants. Such systems are affordable for larger entities, but possibly not yet cost effective for smaller organizations. Auditors will probably continue to provide assurance that the internal controls are effective in either case, and signoffs from key personnel will be part of nearly all systems. □

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The CPA Journal

programs and comply with complex reporting and internal control requirements. Many believe that the threshold should be in the budgetary range of \$3.5 million to \$6 million. There is also concern about a not-for-profit's ability to attract qualified financial personnel that can guide the organization in meeting the proposed legislation's requirements.

Another concern is the potential impact on the ability to attract board members. The requirement to have both executive and audit committees may be difficult for small boards. The requirement for certifications related to the review of the financial statements, and the establishment of internal controls adequate to the organization's needs, will be difficult criteria for any board to meet. Board members are volunteers with an interest in the organization's program or mission. Most do not have financial expertise. Many small not-for-profits, and even some large organizations, cannot attract board members. Additional requirements may negatively affect the recruitment of interested individuals, especially as officers.

Board members would be expected to challenge management and require verification of matters related to financial control, where they might not have done so before. The potential friction between the parties is a goal of the Attorney General's office.

Assistant Attorney General William Josephson, head of the Charities Bureau, has commented, "The statute is trying to create tension between the audit committee and management." Josephson went on to say that the fact that the board members are volunteers is irrelevant. "If you have a president or treasurer's title, we [the Attorney General's office] expect you to stand up to the plate and take a swing, whether you are paid or not ... Volunteer board members are going to have to learn some new skills."

While the board should be more demanding and challenging of management, it would be counterproductive to have an adversarial relationship. A working relationship requires management to understand its responsibilities, possess the resources to fulfill them, and understand what the board needs to be effective. In addition, the board must require that management provide internal controls that are sufficient to safeguard the organization's assets.

Improvements Needed

While the proposed legislation has not been passed, it is probable that there will be changes in the governance requirements for not-for-profits. Even absent legislation, it is fair to say that the relationship between many not-for-profit organizations' board and executive management, as it relates to financial reporting and control, requires substantial improvement. Improvements could occur in the following areas:

Education. Board and management frequently need help in learning about financial controls and systems, such as budgeting, financial reporting, cash flow projections, and using lines of credit.

Financial controls. The following are possible financial control initiatives a not-for-profit organization could implement:

- Introduce processes and procedures that protect assets, limit liabilities, and cur-



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PROPOSED LEGISLATION BY THE NEW YORK STATE ATTORNEY GENERAL

The major points of the Attorney General's legislation, aimed at improving the financial management and internal controls of not-for-profit organizations, are as follows:

Certification Requirement

The president and treasurer of an organization, which has gross revenue in any given year in excess of \$250,000, must certify the following:

- The annual report of the entity, whether or not audited by a CPA, has been reviewed by the signing officer.
- Based on the officer's knowledge, the annual report does not contain any untrue statement of material fact, or omit to state a necessary material fact, in order to make the statements made, in light of the circumstances under which such statements were made, not misleading.
- Based on the officer's knowledge, the financial statements and other financial information included in the report fairly present, in all material respects, the financial condition and results of operations of the corporation for the periods presented in the report.
- The signing officers—
 - are responsible for establishing and maintaining internal controls;
 - have designed internal controls to ensure that material information relating to the corporation is made known to officers by others within those entities, particularly when the periodic reports are being prepared;
 - have evaluated the effectiveness of the corporation's internal controls (within 90 days prior to the report); and
 - have presented in the report their conclusion about the effectiveness of their internal controls, based on their evaluation as of that date.
- The signing officers have disclosed to the corporation's auditors and the audit committee of the board of directors (or person fulfilling the equivalent function)—
 - all significant deficiencies in the design or operation of internal controls which could adversely affect the corporation's ability to record, process, summarize, and report financial data, as well as any material weaknesses in internal controls;
 - any fraud, material or immaterial, that involves management or other employees who have a significant role in the corporation's internal controls;
 - any significant changes in internal controls or other factors that could significantly affect internal controls subsequent to their evaluation, including any corrective actions with regard to significant and material weaknesses.

Requirement to Establish Executive and Audit Committees

If the certificate of incorporation or the bylaws so permit, the board of a corporation with annual gross revenues and support in excess of \$250,000 must designate from among its members an executive committee and an audit committee, each consisting of three or more directors.

The audit committee, or the entire board of directors in the case of corporations whose certificate of incorporation or bylaws prohibit the appointment of an audit committee, is directly responsible for the appointment, compensation, and oversight of any registered public accounting firm employed by that corporation (including resolution of disagreements between management and the auditor regarding financial reporting), for the purpose of preparing or issuing an audit report or related work. Firms report directly to the audit committee.

Each member of the audit committee must be a member of the board of directors and cannot accept any consulting, advisory, or other compensatory fee from the corporation or have participated in any interested party transactions within the previous year.

Each audit committee must establish procedures for the receipt, retention, and treatment of complaints received about accounting, internal accounting controls, or auditing matters, as well as any questionable matters in these areas.

Contracts Between Interested Directors and Officers or Their Associated Organizations

No contract or other transaction entered into between a corporation and an affiliate's directors or officers, or between a corporation and any other entity in which an affiliate's directors or officers are also directors or officers (or have a substantial financial interest), can be voided by the corporation for this reason alone. Nor can they be voided because such directors or officers are present at the meeting of the board (or a committee thereof) at which such a contract or transaction was authorized or voted on by such persons. Notwithstanding the foregoing, such a contract or transaction may be voided or modified by the corporation or the Attorney General. Remedies would be available to the corporation or the Attorney General unless the interested director or officer establishes that he acted in good faith, or unless the interested director or officer (or any approving director) establishes affirmatively that the contract or transaction was fair and reasonable at the time the corporation entered into such contract or transaction.

There are stipulations within the proposed legislation as to the definition of fair and reasonable with regard to the corporation; they should be reviewed if the issue arises. In addition to voiding the contract, the entity may attempt to recover its costs from the interested director or officer.

Compensation of Officers

Compensation of officers in any capacity, including for service as a director or officer of another entity on behalf of the corporation, must be fixed. In the case of compensation by an affiliate, it may be ratified by the affirmative vote of a majority of the entire board.

Indemnification

The legislation places limitations on indemnification by the entity of its directors and officers. □

tail abuse of personal expenditures; including cash controls, monitoring fixed assets, setting up an approval process for incurring liabilities and bill payment, and limitations on credit card use.

■ Integrate the financial department into the entire organization to promote more efficient operations. Operational decisions must be evaluated upon their financial merits, and the financial department must view itself as more than just recording transactions and generating financial reports.

■ Segregate the duties of financial and executive personnel to the greatest extent possible, so that no one person has control. Employees should be encouraged to report to the board any suspicion of wrongdoing. Where duties cannot be segregated outside auditors should increase their scrutiny.

■ Train management and the board to be alert to potential areas where fraud could exist, so that board members, particularly the audit committee, understand what is expected of them. They also should be aware of external resources available to help fulfill their function.

■ Assist the organization in the development of an accounting manual that details the responsibilities of the various financial functions, as well as actual accounting function processes. This manual should be a common reference for the audit committee, the accounting department, and management.

Audit committee training and assistance. The members of not-for-profit audit committees often lack the background and experience to be properly effective. The following areas may need focus:

■ Understanding the purpose, nature, processes, and outcomes of an audit.

■ Using the auditors to investigate and conduct thorough analyses of selected areas.

■ Reviewing and approving the annual financial statements and auditor's reports.

■ Establishing standards for signoffs and required certifications. Officers that must sign off on required certifications will in turn require signoffs from key staff members; the issue is the effectiveness of these certifications. Procedures must be established to provide assurance from internal and external sources (see the Sidebar).

■ Meeting with the auditors independently of management. A board that challenges the accuracy of financial statements and inquires about the quality of financial controls will

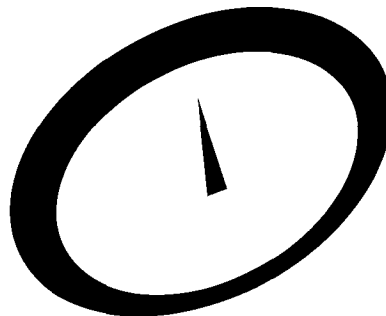
generate friction with management. This could be due to both a lack of understanding and an inability to communicate both questions and answers. A dispassionate intermediary can be essential in resolving difficult issues.

Improving the financial system. Many not-for-profit organizations have rudimentary financial systems. The proposed legislation will provide incentives for improved

accounting systems. The goal should be not only to improve financial reporting and control, but also to provide management with more useful information. □

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