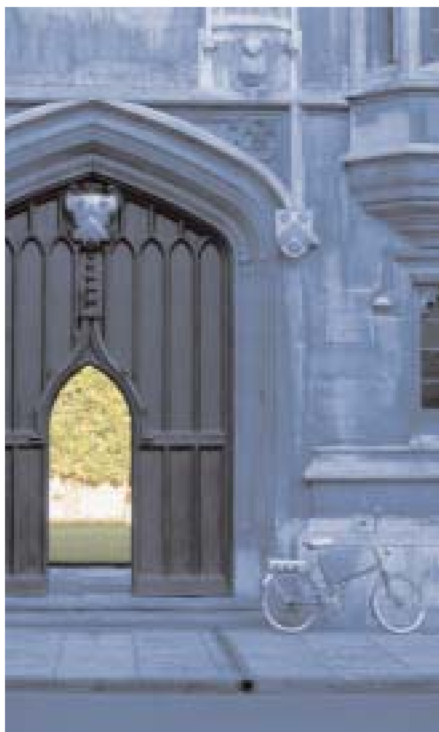
AUDIT COMMITTEE INSTITUTE

Strengthening Governance and Accountability

Higher Education, Charities, and Other Not-for-Profit Organizations

Nearly two years have passed since the Sarbanes-Oxley Act was signed into law in response to a wave of highly publicized corporate accounting scandals. While applicable only to publicly traded companies, the impact of its provisions is now cascading to private organizations, including not-for-profits. Sarbanes-Oxley is just one aspect of an emerging consensus that greater attention is required on the broader issues of governance and accountability. While a governing board's financial oversight role has received the most critical attention, some discussion of its overall responsibilities is warranted.



"Communicating with Audit Committees since 1999"

The Better Business Bureau's BBB Wise Giving Alliance *Standards for Charity Accountability* describes the primacy of the board's responsibility clearly: "The governing board has the ultimate oversight authority for any charitable organization." Echoing that message when commenting recently on governance issues at a private foundation, the Attorney General of Missouri said, "The board needs to play a more active role in its oversight of foundation affairs so that the accountability for the foundation's actions clearly and demonstrably lies with the board."

In its *Special Report: Corporate Governance Best Practices, A Blueprint for the Post-Enron Era,* The Conference Board defined the board's duty (and relationship to management) as follows: "to focus on guidance and strategic oversight, while it is management's duty to run the business with the goal of increasing shareholder value for the long term." In this corporate definition, one can identify a fundamental truth that complicates the responsibilities of the not-for-profit board member: *no one "owns" the not-for-profit organization.* Multiple stakeholders rather than shareholders have legitimate interests in the organization, but not an ownership interest. Not-for-profit boards are ultimately accountable to both a stated mission and the interests of diverse constituencies.

The Conference Board's report cites two basic legal requirements of the board member's role:

- *The duty of care*—to be informed and exercise appropriate diligence in making decisions and in overseeing management
- *The duty of loyalty*—to put the interests of the organization before those of the individual board member

While the dynamics of each board are unique, all boards and their members should abide by these basic requirements.

Approaches we have observed by boards stem not only from the leadership of individual members but also from the organizational cultures associated with various not-for-profit segments. For example, colleges and universities generally display a shared governance model with faculty having an important role in setting academic policy. Member organizations are generally governed by a subset of elected members. Human services organizations frequently structure their boards to include strong national or local community leaders, depending on the reach of their programs. These models can vary dramatically in form and substance, but all should share a common objective: furthering the mission and protecting the organization's reputation with its constituents.

There is now a growing body of literature and articulated views devoted to not-for-profit governance. The following principles and guidelines have been gleaned from several sources, notably the *Statement of Values and Code of Ethics for Nonprofit and Philanthropic Organizations* issued by Independent Sector (available free of charge at: www.independentsector.org/members/code_main.html).

Governance Principles and Guidelines

The governing board:

- Is responsible for setting the mission and strategic direction of the organization and for oversight of its finances, operations, and policies
- Ensures that its members have the requisite skills and experience to carry out their duties and that all members understand and fulfill their duties acting for the benefit of the organization and its public purpose
- Has a conflict of interest policy that ensures that any conflicts of interest or the appearance thereof are avoided or appropriately managed through disclosure, recusal, or other means
- Is responsible for the hiring, firing, and regular review of the performance of the chief executive officer, and ensures that the compensation of the CEO is reasonable and appropriate
- Ensures that the CEO and appropriate staff provide the board with timely and comprehensive information so that the board can effectively carry out its duties
- Oversees compliance with laws and regulations and sets (and insists upon) an ethical "tone at the top"
- Ensures that all new members participate in an orientation program and that continuing education is provided
- Assesses its own effectiveness

In the current environment, it has become painfully clear that not-for-profit board members must accept that their role extends well beyond that of adviser or benefactor. To govern is to accept the responsibility of oversight and to exercise the accompanying authority that such oversight necessitates: asking probing questions and, when appropriate, challenging the answers to those questions. In *Boardrooms That Work*, Margot Cairnes says, "Boards need to create a culture in which trust, respect, candor and open, constructive dissent are the norms."

Stewardship of the institution's assets is an important element of the board's responsibility. There are no more important assets to the not-for-profit enterprise than its intangibles: reputation, brand, and public trust. Continued focus on protecting public reputation should cause all boards to examine their own governance policies if such a review has not taken place in recent years.

Another key board responsibility is risk assessment. Understanding the organization's vulnerabilities—strategic, operational, and financial—is essential to ensuring that a process is in place to assess and manage those risks. Frequently, the board delegates responsibility for financial risk assessment and mitigation oversight to the audit committee—often a very appropriate body for this element of board oversight, especially where there is a robust internal audit function.

Where is all this activity headed? There is no lack of voices and suggestions coming from both public and private sector observers:

- In November 2003 the National Association of College and University Business Officers issued a white paper entitled *The Sarbanes-Oxley Act of 2002: Recommendations for Higher Education*.
- In December 2003, BoardSource and Independent Sector jointly issued *The Sarbanes-Oxley Act and Implications for Nonprofit Organizations*.
- Following the lead of Elliot Spitzer in New York, the attorneys general of both Massachusetts and California have proposed legislation with Sarbanes-Oxley-like elements applicable to not-for-profits in their states.
- In January 2004, Fitch Ratings issued a Higher Education Special Report entitled *Sarbanes-Oxley Act: Voluntary Compliance Viewed as a Best Management Practice*.

Whether any of the efforts to enact legislation "to enhance the financial integrity of public charities" (as Thomas A. Reilly, attorney general of Massachusetts, characterized his proposal) lead to new mandates is yet to be seen. In the meantime, we suggest there are steps not-for-profits can *and should* take because they represent emerging best practices at this stage. Many organizations have recently adopted some or all of these policies if they were not already in place. In addition to the broader governance issues discussed above, KPMG believes the boards of not-for-profits should seriously consider:

- Appointing an audit committee (for some organizations a combined finance and audit committee may be appropriate) comprising independent board members with the skills and time to discharge the committee's fiduciary duties and responsibilities
- Adopting an audit committee charter that delineates the committee's responsibilities, policies, and practices. The charter assists the full board and committee members in understanding the duties and boundaries of the committee. We have seen some organizations assert that they do not need committee charters—that sufficient guidance exists in their bylaws. In our experience, most bylaws are far more general than a charter should be. An ancillary benefit of the charter is that updates can be made without requiring bylaw amendment. Within the context of the specifics of the organization, the following Sarbanes-Oxley elements should be considered for inclusion in the audit committee charter:
  - Acknowledge the committee's responsibility for the appointment, compensation, and oversight of the external auditors and, if applicable, internal auditors. For many organizations, this primacy of auditor–audit committee relationship represents substantial change.
  - Require committee pre-approval of non-audit services performed by the external audit firm (non-audit services may be limited by U.S. Government Accounting Office Independence Standards).
  - Establish procedures to address "whistleblower complaints" regarding ethics, integrity, internal controls, and accounting or auditing matters. This may have been a "consider" item shortly after it was mandated in public companies, but despite concerns about "separating the wheat from the chaff" there is a good deal of evidence that this is one of the best ways to uncover questionable acts or fraud.
- Adopting a policy with respect to audit partner rotation. A range of between 5 and 10 years should be considered as should a provision for committee-approved extensions if circumstances warrant.
- Evaluating the effectiveness of internal controls and assessing the adequacy of controls documentation. If warranted, a plan to enhance such documentation should be developed. Although many organizations have various forms of controls documentation, most have never comprehensively documented and evaluated controls. In the absence of the management assertion and auditor attestation requirements of Sarbanes-Oxley section 404, the debate with respect to a controls documentation project relates to the extent of documentation and the urgency with which the project should be undertaken. There are certainly benefits to be gleaned by many not-for-profit organizations from a detailed evaluation and documentation of controls. Such an effort may reveal unnecessary or duplicate controls as well as areas for improvement, while providing a great deal of information about processes and risks. In its recently issued *Sarbanes-Oxley Compliance: A Foundation for Future Business Value*, KPMG LLP (U.S.) discusses how companies can use what they have learned from implementation efforts to date to identify opportunities to enhance overall operations.
- Requiring a "statement of management's responsibility," perhaps incorporating a discussion of the organization's dedication to strong governance practices. While such a statement may fall short of the certifications required by Sarbanes-Oxley, the expression of responsibility is consistent with the underlying spirit of accountability. These public statements are appearing more often within the not-for-profit sector, typically presented in an annual report that accompanies the audited financial statements.

In a March 2004 *New York Times* article, Stephanie Strom reported, "Charities and foundations have been bracing for stronger regulatory intervention in their affairs, and many are already taking steps to beef up their governance, adopting or strengthening policies on conflict of interest, creating audit committees and adding independent directors to their boards."

We believe that the self-interest of the not-for-profit sector argues for moving toward voluntary adoption of strong governance and accountability principles even if legislative mandates are stalled. There has been no time of greater attention to these issues, and not-for-profit organizations may have only a small "window" to seize this opportunity to improve the performance of their boards and the transparency of their public disclosures. Ultimately these enhancements should yield better-run institutions and, more importantly, protect and bolster public trust.

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