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Playing by the rules

Although not affected by new federal guidelines, some nonprofits take steps to improve corporate governance

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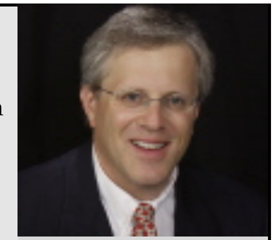
Business First Staff Writer

As public companies scramble to comply with new federal corporate governance regulations, officials with local nonprofit organizations and some privately held companies are examining the rules and wondering if they are next.

One nonprofit organization that has taken steps to address corporate governance issues is Brooklawn, a Louisville facility that provides mental health services for troubled children and families, including residential treatment, special education, and in-home support.

"When the whole thing with Enron and corporate governance hit the newspapers, I think our board was aware of the concern for not only for-profits, but nonprofits in terms of the governance," said David Graves, president and CEO of Brooklawn.

"The first thing that our board president did last year was to arrange for our auditor to come and meet with the full board," Graves added. At the meeting, board members had the opportunity to ask questions and better understand the auditing process.



Peter Resnik

Peter Resnik is a chartered financial analyst *(sic)* and CPA who has worked on corporate and nonprofit turnarounds, most recently as acting executive director of the Jewish Community Center of Louisville. He offers the following questions as an example of what potential board members should ask management before agreeing to serve on a board:

1. **Are revenues and expenses associated with services sufficiently identified and supported?** All revenues (such as fees, donations, grants and investment income) and expenses should be identified for analyzing what it takes to operate programs. Services provided need to be priced properly. Fixed and variable expenses should be fairly considered.
2. **Does cash flow support the operations?** Beyond financial projections and accounting results, cash must be available when needed to meet obligations. Particular focus should be directed toward collecting receivables timely, along with assuring regulatory tax authorities and vendors are paid according to guidelines.
3. **Do interim financial reports prepared by management for board directors reconcile to annual audited financial statements?** An audit usually performed at least annually provides an independent opinion as to whether financial statements are presented in accordance with accounting principles. In addition, management may provide the board with more frequent internal reports on the organization's financial and operating condition.
4. **Are recommendations from auditors on internal controls addressed timely?** Independent auditors normally provide a letter outlining internal control risks that management may want to consider rectifying. Directors should discuss the implications of these risks directly with management and the auditors and then follow up on the implementation of changes.
5. **Are administrative procedures and resources reviewed for efficiency?** Inefficient workflow procedures that underutilize staff time and other resources often evolve over time. They should be periodically reviewed and updated regardless of organizational structure or individual territory. Also, software technology offers meaningful reports, strengthened controls and enhanced customer service — when staff is adequately trained to implement the software fully.
6. **Are investment funds properly recorded and used for their intended purpose?** Contributions classified as temporary or permanently restricted assets are subject to donor and regulatory requirements for their release and use in operations. Directors should review that funds are properly tracked and reported to maintain donor confidence.
7. **Is sufficient attention placed on minimizing downside-operating risk?** Potential risks and hazards that could impact the organization's ability to provide future services should be identified and actions taken to minimize their occurrence. Prioritizing them can be based on the likelihood of the events transpiring and the materiality of the impact if they should. Procedure manuals, computer data back-up and personnel policies all can help protect assets.

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That increased knowledge and interaction is a critical piece of recent accounting industry reforms, local accountants said. However, the Sarbanes-Oxley Act of 2002 only mandated changes in how public companies work with accounting firms.

Sarbanes-Oxley encourages checks and balances to prevent future corporate scandals the likes of highly publicized financial catastrophes at Enron Inc. and WorldCom. In the event that illegal activities slip through the cracks at a public company in the future, it also set stiff penalties for CEOs, chief financial officers, board members and auditors.

Sarbanes-Oxley -- which was named after its sponsors. Sen. Paul Sarbanes, D-Md., and Rep. Michael Oxley, R-Ohio, -- was signed into law by President Bush on July 30, 2002. The act has a variety of implementation deadlines, some of which already have taken effect and others that have been delayed until next year.

Because Sarbanes-Oxley applies only to publicly traded companies, nonprofit organizations and private companies do not fall under the law's umbrella.

"In theory, it doesn't apply to our company base," said Bob Montgomery, president of Cotton & Allen PSC, a local accounting firm that works with nonprofits and private companies.

Still, officials with area nonprofit organizations are considering changes they might make in light of the new law to ensure proper procedures are in place to prevent financial malfeasance and to maintain operational integrity.

"There has been a fair amount of discussion in the board room and with management about the issue," said Kevin Connelly, executive director of the Center for Nonprofit Excellence, a Louisville organization that provides consultation, information and research, and coordinates training for not-for-profit groups.

"Because so much of that act is concerning such large-scale and large-impact issues in mostly the for-profit sector, that's where most of it is being absorbed and attended to," Connelly said. "But the principles related to consulting and the independence of an audit have applications beyond, obviously."

Local nonprofits begin to make changes

Many local organizations are opting to use Sarbanes-Oxley as a guideline and are adopting some portions of the legislation -- such as picking board members more carefully and ensuring that audit committee members are totally independent from the organization, local accountants said.

"We're going to see a trend where nonprofits -- and I think private companies in general -- are going to be focusing on their governance," said Tony Smith, professional practice director for the Ohio Valley Area of Ernst & Young LP accounting firm. "We're seeing some of them that are voluntarily complying with Sarbanes-Oxley."

Jerry Hurt, managing partner of Deming, Malone, Livesay & Ostroff PSC accounting firm, said audit committee members already have started taking a more active role -- on nonprofit boards as well as boards of publicly traded companies.

About 25 percent of DMLO's business is with nonprofit clients, and the remaining 75 percent is with private companies.

He added that the biggest impact he has seen to date is "that a lot of nonprofits are being more careful" and updating their corporate governance policies and procedures.

Legislation expected to have far-reaching impact

Accountants agree that the effects of Sarbanes-Oxley will extend beyond the public companies covered in the legislation.

"I think Sarbanes-Oxley will be what (Equal Employment Opportunity) was 20 years ago" when businesses not required to by law began to follow employment guidelines mandated for larger employers, said Stephen Tisdell, principal in Nashville Management Group Inc., a Nashville-based company that provides consulting, advisory and management services for businesses.

"It's not going to be taken (as) hard by the private sector as it is in the public company format, but some forms of it will be taken on," said Tisdell, who frequently speaks on the topic and recently presented a program in Louisville.

"Obviously, it's having far more reaching impact (than the law specifically laid out) because other individuals are paying attention to what's going on in the public environment, and they're starting to look at Sarbanes-Oxley," said Neal Spencer, partner-in-charge of the Louisville/Southern Indiana region of BKD LLP, a Springfield, Mo.-based accounting firm that works with nonprofit and private clients.

Further action could come on state level

Sarbanes-Oxley opens the door for state legislators to pass similar laws, which then could be extended to private companies and nonprofit organizations, local accountants said.

"Some of the states are considering implementing those rules as it relates to the not-for-profit enterprises that are out there," Spencer said. "We are seeing a lot of discussion."

This type of trickle-down legislation may well reach nonprofits and private companies, local accountants said.

If that happens then the amount of work required to complete the audit would increase, Spencer said. The increase in work would result in an increase in audit fees. Increasing the cost for their services is a concern for accounting professionals who already are dealing with a need to improve the industry's image in the wake of last year's corporate scandals. Also, nonprofits especially have little room in their budgets for increased fees, he said.

Nonprofits take steps to improve control

Some nonprofits are not waiting for mandates to update their governance processes.

Brooklawn officials already have implemented a new internal process for when the organization's finished audit is presented by its accountant to the finance committee.

"At the end of the presentation, all the employees are asked to leave the room so that the finance committee can meet with the auditor without any staff present to ask any questions they might have," Graves said. Often, board members won't ask tough questions when employees are present, he added.

Another organization "in the process of getting educated" about Sarbanes-Oxley is Jewish Hospital HealthCare Services Inc., said Alan Broude, chief financial officer for the Louisville-based, non-for-profit health care company.

Although "a lot of Sarbanes-Oxley does not apply to us because we are not a public company," he said, there are "some good basic business principles that we'll probably adopt once we get a better understanding of what (Sarbanes-Oxley) is and we take the education process to our board."

Broude added that this topic is "on the radar screen" of board chairman Julian L. Shapero, and that any changes would "be board-driven rather than management-driven."

Rotation of firms draws concern

One requirement of Sarbanes-Oxley is that publicly traded companies rotate audit firms periodically.

But for nonprofit organizations and privately held companies, rotating auditors isn't necessarily practical, said Montgomery, of Cotton & Allen.

"To go in and just do an audit would not really serve our client base well," Montgomery said. "We gain a lot of knowledge about their businesses. It really doesn't make much sense (to change auditors periodically). ... We just really don't see the need for the separation of services."
Spencer said that rather than changing auditors, many of his nonprofit clients are "really using Sarbanes-Oxley as a way to re-evaluate their relationship with the accounting firms."

Graves said his board evaluated the strength of Brooklawn's audit firm, DMLO, and determined that DMLO auditors are "the experts in the field" of health care reimbursement.

"After they explained how they've heightened their internal safeguards, our board felt comfortable using them without going to another firm," he said.

For example, DMLO has implemented a new policy that calls for auditors to be rotated to different client organizations, and the firm has increased its auditors' interactions with the board audit committees, Hurt said. Another "general trend" among nonprofits is an increasing focus on possible conflicts of interest between auditors and nonprofits, Connelly said.

Board members and organization executives are "going to be more attuned to that to make sure that there is no perception of the lack of independence," Montgomery said.

Protective steps are not new for Brooklawn

But having corporate governance measures in place is nothing new for Brooklawn, Graves said.

For example, board members are elected for three-year terms and are limited to two terms. Because of those limitations, "we're constantly bringing new people to serve on the board," Graves said.

Also, a new person is rotated onto the finance committee each year.

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New members must go through an orientation process before joining the board, Graves said. That orientation includes information about liability insurance and volunteer exposure to risk.

"You're expected to ask questions and be informed," Graves said. "They're expected to be active board members and be informed about all of the agency operations."

Brooklawn currently has 23 board members from a "broad range of backgrounds," and the board includes people "who have expertise in finance," Graves said.

Their knowledge is key because it could improve donors' confidence in the financial stability of the organization, said Tisdell of Nashville Management Group Inc.
"The last thing a donor wants to see in a nonprofit is (it) being sued for malfeasance," said Tisdell, who is also president of Catholic Charities of Nashville. "Most definitely, all nonprofits are beefing up their boards with financial people. There's even discussion of conflict-of-interest questionnaires."

Board members are key to success

The steps Brooklawn has taken follow the advice that many local accountants are providing to their clients.

"I think there's just more board awareness and more board active awareness of what's going on," said Rob Wedding, a BKD partner who works in the firm's Evansville, Ind., office. "That, I think, is a very healthy process."

When asked to join a nonprofit's board, local business executives should take an active role, said Peter Resnik, who has worked on corporate and nonprofit turnarounds, recently as acting executive director of the Jewish Community Center of Louisville. Board members should ensure that nonprofits "are meeting their fiduciary responsibility and carrying forth the organization's mission with appropriate financial and operating discipline," Resnick said. *(underline emphasis added)*

Nonprofit organizations need to court board members who will take an active role, industry watchers said.

"The board composition issue is kind of first and foremost," Tisdell said. "What we tend to do, unfortunately, is the people that give a lot of money or have a big interest" in the organization are "dominant" on nonprofit boards.

"That's just not a healthy environment to create," added Tisdell. "Basically, with your board you want to have safeguards."

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