Accountability Matters

Without the public trust, nonprofits wouldn't exist

Executive Summary

Accountability may be a hot topic in the corporate world, but it is not the responsibility of companies alone. Just as investors want assurances that publicly traded companies are ethically and financially sound, donors are increasingly demanding to see measurable results from their donations. As a result, nonprofit organizations need to think about how they operate and put in place savvy strategies to earn and maintain the public trust. Without the trust of the public, there would be no charitable sector. The good news is that nonprofits are taking key steps to make their processes more effective and their activities more transparent. The bottom line: this accountability is both good stewardship and good for the bottom line.

Accountability Matters

Without the public trust, nonprofits wouldn't exist

Liz Marenakos, Product Line Manager, The Financial Edge™ and The Information Edge™

Contents

The New Accountability

Accountability is all about being answerable to those who have invested their trust, faith, and money in you. Nonprofits must be accountable to multiple stakeholders, including private and institutional donors; local, state, and federal agencies; volunteers; program recipients; and the public at large. And everyone who works for a nonprofit, whether as a paid staff member or a volunteer board director, has a role to play in ensuring the organization is answerable to its constituents.

Chief financial officers, for example, must file accurate and timely tax forms, and provide legible financial reports to board members and major donors. Fundraisers need to report back to donors on how their dollars were spent. Board members, meanwhile, need to provide sound fiduciary and management oversight to ensure that the nonprofit's activities are efficient and transparent, and that its reputation remains above reproach.

There are three components to accountability — financial and regulatory compliance, stewardship, and donor trust. To establish accountability across an organization, every department must both comply with nonprofit financial standards and demonstrate to key stakeholders that it has put in place the systems and oversight needed to manage funds. And when problems arise, nonprofits need to acknowledge them, fix them, and move on. To do otherwise is to risk ending up in the headlines for all the wrong reasons.

"A Vibrant Nonprofit Sector"

Scandals at Enron®, WorldCom™, and Arthur Andersen destroyed the companies and rocked the corporate world, in the process costing thousands of investors millions of dollars in retirement savings and other income. They also did something else: galvanized public attention on how organizations are run and what safeguards might be needed to avoid similar financial fraud in the future. From this debate came a new federal law: The Sarbanes-Oxley Act. Enacted in 2002, the law — which applies to publicly traded companies — addresses accounting oversight, auditor independence, corporate responsibility, enhanced financial disclosures, and other elements of sound governance.

On a smaller scale, there have been some high-profile cases of fraud and financial mismanagement at charities in the United States. Scandals at these and other charities have taken their toll on donor trust and propelled nonprofits to focus more directly on their own accountability and the reputation of the sector as a whole.

On a smaller scale, there have been some high-profile cases of fraud and financial mismanagement at charities in the United States. For example, the chief financial officer of a major university foundation was arrested and charged with embezzling $700,000, and a religious organization declared bankruptcy after defrauding 13,000 investors. Scandals at these and other charities have taken their toll on donor trust and propelled nonprofits to focus more directly on their own accountability and the reputation of the sector as a whole. As part of this examination, a key U.S. Senate committee is working with the charitable sector to craft an accountability law for nonprofits.

"A vibrant nonprofit sector is critical for a vital America,"[1] wrote the Panel on the Nonprofit Sector in its interim report to the Senate Finance Committee. The panel also stressed that the nonprofit sector's effectiveness "depends on its independence" and its success on "its integrity and credibility." The interim report sets out key recommendations:

- To improve the transparency of charitable organizations
- To enhance governance in charitable organizations
- To strengthen government oversight of charitable organizations

The panel also plans to address strategies to strengthen "the governance, ethics, and accountability of charitable organizations" in its final report.

The details of the recommendations in many ways parallel the provisions put in place under Sarbanes-Oxley. For example, the interim report recommends that financial returns be signed — under penalty of perjury — by a key top-ranking official at the charitable organization. The report also recommends that organizations with $2 million or more in total annual revenues conduct an audit of their financial statements, and that there be a financial competency standard for nonprofit boards.

While the U.S. Senate is looking at legislative options to strengthen nonprofit accountability, states have not been sitting on the sidelines. Several states, including California, Iowa, and Maine, enacted measures in 2004 addressing everything from financial reporting to avoiding conflicts of interest. Most notably, California's Nonprofit Integrity Act imposes new financial requirements on nonprofits, including a requirement that audits be available to the public and that each nonprofit "establish and exercise control over its fundraising activities conducted for its benefit, including approval of all contracts and agreements." In addition, nonprofits must "assure that fundraising activities are conducted without coercion."

Other states, including Hawaii, Massachusetts, Michigan, Ohio, and Rhode Island, have proposals in the pipeline. Hawaii's attorney general wants the legal authority to remove directors and officers who breach their duties. Massachusetts' attorney general has proposed a broad set of measures, including triggering a mandatory audit for any nonprofit with total annual revenues

[1] *Interim Report.* Panel on the Nonprofit Sector. Presented to the Senate Finance Committee, March 1, 2005.

over $750,000. The proposal would also require managing officers of large public charities to certify both the accuracy of financial statements and that officers have established disclosure and internal controls over financial reporting.

When Nonprofits Fall Short

Legislative measures, both those enacted and those under consideration, are designed to set out benchmarks for nonprofit accountability. Without accountability standards in place, a nonprofit risks losing the trust of donors, volunteers, and other key stakeholders.

Legislative measures, both those enacted and those under consideration, are designed to set out benchmarks for nonprofit accountability. Without accountability standards in place, a nonprofit risks losing the trust of donors, volunteers, and other key stakeholders.

Take, for example, a theater that failed to report to the Internal Revenue Service (IRS) that it had established a for-profit subsidiary. During a random IRS audit, the agency discovered that the theater should have been paying income taxes on the revenue received from sales generated by its for-profit subsidiary. The theater was assessed a penalty by the IRS, and the story was splashed across the newspapers and the nightly newscasts. In addition to the negative press, there was also significant tension between the staff and the board of directors. As a result of the scandal, the theater lost the trust of several major donors.

Or take the case of a university foundation that continued to spend significant money during a time of decreased private donations and cuts in government funding. Because the foundation was using a for-profit accounting system that didn't allow staff members to track expenditures by fund, it was using a spreadsheet to fill in the gap. When the auditor reconciled the spreadsheet with the accounting system at the end of the year, he discovered that the foundation had been consistently spending restricted funds inappropriately. In addition to being a violation of state law, the action violated accounting standards and the university's own ethics policy. As a result, several key board members were forced to resign, and the public scandal dampened donor interest in supporting the foundation.

While the previous examples address lapses in *internal* accountability standards, how a nonprofit interacts with current and potential donors is equally important. Take the case of a donor who makes significant gifts to several organizations in her community. Among them is a local environmental coalition and an HIV/AIDS clinic. The environmental coalition uses a combination of email, personalized Web content, and face-to-face meetings to keep the donor updated on how her money is being spent. The HIV/AIDS clinic, on the other hand, merely sends out a standard thank-you letter and puts the donor on the mailing list for the organization's quarterly newsletter. As a result, when the donor meets with her financial advisor to discuss donations for the upcoming year, she decides to give the environmental coalition a much larger gift and to eliminate the clinic from her plans. This highlights why it is important for nonprofits not only to *do* the right things, but also to engage donors by reporting regularly to them about how their dollars are being spent.

Establishing Accountability

The good news is that there are steps that nonprofits can take to make their financial processes more effective and their activities more transparent. These steps fall into what Thomas

An organization's audit committee — made up of several board members — should be responsible for monitoring financial reporting, internal controls, and business risks. In order to do their jobs, committee members must understand finances and have a working knowledge of the systems in place to track the organization's finances.

***Liz Marenakos** is the product line manager for Blackbaud's financial management and data analysis solutions. She has served on the boards of several nonprofits, in roles ranging from treasurer to vice president. She has also served as the financial manager of a nonprofit organization, managing several fundraising events and participating in capital campaigns.*

Before joining Blackbaud, she performed business planning and tax preparation for a small public accounting firm and ran her own business for four years. Additionally, she worked on a forensic accounting project with a federal court-appointed receiver, responsible for the complete reconstruction of a general ledger. Ms. Marenakos holds a BS in international politics from Georgetown University, a Master of Accountancy degree from The University of Charleston, and is currently enrolled in the MBA program at The Citadel.

McLaughlin, a consultant at Grant Thornton, a leading financial and business advisory firm, calls the four principles of accountability[2]:

- Systems (procedures and technologies, including internal controls and smart software that produce predictable results)
- Oversight (including financial reporting and solid governance structures)
- Culture (an intangible quality that reflects the values of the organization)
- Knowledge (professional financial expertise, along with a well-trained board and staff)

While "SOCK" is a good way to think about accountability, in practical terms nonprofits have to translate these principles into actionable items. These include:

- Establishing an audit committee
- Ensuring auditor communications with the board
- Defining organizational policies and monitoring compliance
- Reporting finances
- Establishing internal controls
- Providing for whistle blowers
- Public disclosure

Here is a brief look at each item.

An organization's *audit committee* — made up of several board members — should be responsible for monitoring financial reporting, internal controls, and business risks. In order to do their jobs, committee members must understand finances and have a working knowledge of the systems in place to track the organization's finances. A key component of this process is sound technology. For example, many nonprofits use both accounting software and a basic spreadsheet to track finances. Audit committee members need to understand how these systems are integrated and be vigilant against the risk of duplicate data entry, and even fraud.

Audit committees also need to *hear directly from auditors* — and not have the information filtered through the CEO, chief financial officer, or other key staff members. Once an audit is complete, the auditor should meet with the board to discuss the findings, including an assessment of the organization's internal controls.

Nonprofit boards need to make sure that the organization has *written policies and procedures* — and that they're being followed at all levels of the organization. Technology can help track compliance, such as allowing a board member or an auditor to trace invoices from receipt through approval, posting, and payment. Technology can also reduce the costs of monitoring, meaning more of the dollars donated to an organization are used for program activities.

Nonprofit CEOs and CFOs should provide *consistent, timely reports* to their boards. Types of reports include a balance sheet, revenues and expenses, pledged receivables, cash flow, and

[2] "Simple Steps to Achieve Greater Accountability and Stewardship," by Thomas A. McLaughlin, Grant Thornton, LLP, November 9,2004.

utilization. A good software system can make it easier for organizations to quickly and easily customize reports.

Internal controls must be in place to provide assurances that a nonprofit's transactions are properly authorized, recorded, and reported, and that the organization's assets are safeguarded. As part of this process, staff members need to know how to configure their software systems to adapt to changing business environments. Board members, meanwhile, need to understand the system's built-in controls, and analyze the system to ensure accountability and transparency.

Although *whistle blowers* have legal protections, it is also important that nonprofits encourage people with concerns to come forward. Nonprofit directors and officers should let staff members, volunteers, and other stakeholders know how they can raise concerns. If an organization listens to its whistle blowers early on, it can save itself a lot of trouble in the long run.

Finally, nonprofits must *disclose financial and governance information* on a regular basis to both donors and the public at large. An organization's annual report, its tax filing, and program activities should be accessible on the Web site, available to be mailed out, and on hand in case someone walks into the office and asks for this information. Timely, consistent reporting to external stakeholders reinforces an organization's accountability and promotes good stewardship.

Conclusion

The charitable sector is based on public trust. Nonprofits count on private donations and government funding to carry out critical services in communities across the United States and around the world. As a result, every nonprofit should have in place a governance structure and strict financial controls in order to assure their stakeholders that every dollar invested in their organization is appropriately allocated and well spent. Nonprofits should also put in place software and other technology to help them to be accountable and to communicate regularly with donors about how their gifts are being used to carry out the nonprofit's mission.

Equally important, stewardship requires that today's nonprofit management invests assets wisely and reasonably for the long term so that those charged with carrying out the mission in the future have access to the same level of financial resources. In the end, good stewardship implies that an organization is using donated dollars wisely. A nonprofit that demonstrates such accountability is responding to those who have invested their trust, faith, and money in that organization.

about Blackbaud

Blackbaud is the leading global provider of software and related services designed specifically for nonprofit organizations. Apprxomately 13,000 organizations use Blackbaud products and consulting services for fundraising, financial management, business intelligence, and school administration. Blackbaud's solutions include The Raiser's Edge®, The Financial Edge™, The Education Edge™, The Patron Edge™, Blackbaud® NetCommunity™, The Information Edge™, WealthPoint™, and ProspectPoint™, as well as a wide range of consulting and educational services. Founded in 1981, Blackbaud is headquartered in Charleston, South Carolina, and has operations in Toronto, Ontario; Glasgow, Scotland; and Sydney, Australia.

For more information about Blackbaud solutions, contact a Blackbaud account representative. In the United States and Canada, call toll-free 800.443.9441. In Europe, call +44 (0) 141 575 0000. Visit us on the Web at **www.blackbaud.com**

Blackbaud