Chapter 1

Governance and Administration

The structure of not-for-profits has always been of major relevance. Yet, officials of not-for-profits are often uninformed as to the history of the not-for-profit sector and even their own agencies. When was the agency founded? In what state was it chartered? What was its stated mission? Where are the articles of incorporation? Is there a written mission statement? These are some of the more significant issues pertaining to governance, but of course there is more information that both professionals and board members should know. What is the structure of the board of directors

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or trustees? How are board members selected? Is there a governance or nominating committee on the board? Does a code of conduct exist? Is there a conflict-of-interest statement? Is there a personnel practice manual? What are the legal and corporate history and mission of the organization?

All not-for-profits, especially those that enjoy a tax exemption [501(c)3], must have a governance structure starting with the existence of a board of directors, sometimes referred to as a board of trustees, board of governors, or board of overseers. The different terms grow out of the unique history of each organization and the relevant language that was used during the time of founding. All organizations require the existence of a legal body or board if they receive tax-exempt status or allow their donors to contribute to a legitimate charitable enterprise.

Sarbanes-Oxley

Many changes have occurred with respect to governance over the past five years. Some have been driven by federal and local oversight requirements and issues growing out of an enlarging philanthropic or charitable industry that has greater visibility and public scrutiny. At the federal level, the Sarbanes-Oxley (SOX) law, largely directed toward publicly held for-profit corporations, has had an enormous impact on the not-for-profit sector, even though it does not directly apply to or govern their operations. SOX raised the bar for oversight, transparency, and accountability. The application of SOX directed agency boards and individual members to seriously look at themselves and determine whether they possess the necessary knowledge, oversight, and system of review and accountability needed to effectively discharge their responsibilities.

The effect of SOX was so immediate that an entire industry of consultants quickly emerged to assist agencies in increasing their accountability mechanisms and responsibilities. Boards learned that they should establish an executive compensation committee, audit committee (to include independent participants), a nominating structure, and clear guidelines with respect to board conflict of interest and self-dealing. Board members of agencies took note and in both large and small not-for-profits a flurry of activity developed. Boards were both awakened and empowered to better understand their roles and responsibilities as directors. At the same time, these new requirements made some board members feel uncomfortable with respect to possible culpability. In some instances board members of not-for-profits had been asked by their employers to accept membership based upon the for-profit's interest in and significant grant to that agency. After SOX, many corporations and corporate foundations questioned whether they were assuming liability as a result of this practice. The corporate leaders did not want to expose themselves to or become culpable for the actions of the not-for-profit board, in which they had official representation. In many cases they withdrew their nominee and discontinued that practice. It is unclear at this stage whether the discontinuance had any significant impact on corporate grant making to not-for-profits. Many not-for-profits have found it more difficult to recruit directors, particularly from the corporate world, which has required agencies to find the funds to increase their directors' and officers' liability insurance policies.

Accountability

Even before SOX, the not-for-profit division of the Internal Revenue Service (IRS) offered both guidelines and directives

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with respect to some of the same issues raised in SOX. In some instances the IRS actually went further than SOX on proposing accountability measures. *Intermediate Sanctions,* an IRS ruling issued in the mid-1990s, prescribed penalties for agencies that did not have proper fiscal review, timely submission of reports, including 990s, which listed the compensation of their five highest-paid executives, and reporting of vendor and consultant compensation.

Intermediate Sanctions also raised questions about self-dealing of boards (vendor relationships) and defined acts of both commission and omission, which could result in penalties or even suspension of the organization's tax-exempt status. These new directives created a reexamination of roles, functions, and responsibilities of boards of trustees. The primary issue of transparency and accountability was heightened after alarming disclosures in the corporate world of Enron, WorldCom, and giant banking enterprises. Not-for-profits, while not in the same league as these giant corporations, were nevertheless being held to a higher standard by government and within rating agencies in the private sector.

Clearly, not-for-profits and, of course, agency executive directors and CEOs should become thoroughly familiar with both SOX and all IRS, state, and local regulations that subject the agency and its board to review. The minutes of all board meetings as well as attendance of board members should be recorded accurately, and copies of the minutes should be stored carefully and sent to the agency's legal counsel for proper retention. Funding sources at the governmental level might request a review of the minutes, especially as it relates to their specific funding (e.g., Head Start, drug prevention or intervention, juvenile justice programs, mental health programs). Agencies might also consider having the minutes of their board meetings posted on the agency's website or in

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other ways made available to the public as a way of increasing notice and transparency.

At least annually, if not more often, attendance of board members at meetings should be reviewed by the nominating committee to determine whether members are sufficiently active to justify their continuation on the board. If board members do not attend at least 60 percent of all meetings, in person or through telecommunication, one should consider appropriate action. Some agencies have established advisory boards or councils that serve to keep board members interested and involved without legal responsibility. Council members are often invited to board meetings and events but are not voting members and do not have either responsibility or culpability for agency policy decisions.

Obviously all required reports should be submitted in a timely fashion, including all federal and local audits, program reports, and important collateral material such as conflict-of-interest statements, serious accidents or deaths that occur while a child is in custody of an agency, and Department of Labor submissions having to do with compliance with civil rights statutes. Where possible the board or one of its committees should be made aware of the content of these reports and in some instances actually participate in the discussions leading to their submission. Placing appropriate reports on an agency website can demonstrate to government regulators and the public that the organization is serious about transparency, public knowledge, and self-awareness.

In recent years, organizations such as the Better Business Bureau and CharityNavigator.com have established review guidelines for not-for-profit compliance and published their findings so that government, donors, and the general public have knowledge of the agency's fiscal and organizational adequacy. CharityNavigator.com applies a "star grading" system

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similar to a Zagat restaurant rating with respect to an agency's administrative and fundraising expenses relative to program expenditures—the lower the administrative expense, the higher the rating. While this practice is helpful, it can also cause agencies to unthinkingly reduce overhead costs to receive a good rating. Doing so can reduce the agency's capacity to supervise and monitor programs and assure quality control. While there is no single standard for administrative expenses relative to programmatic costs, all agencies should carefully review the ratio to assure funders that most of their donations or grants are going for service.

These days, most donors prefer not to give funds for management, supervision, and overhead. They usually designate a restricted gift for a specific program in which they have an interest and at times may instruct the agency not to use any of their gift for administration. This situation has caused many agencies enormous budgetary problems and has created a dilemma in supporting a program with inadequate funds for sound supervision or oversight. Agencies are especially grateful to donors who are wise enough to make grants for general operating expenses, knowing how essential those funds are to the sound operation of any organization.

Organizational Culture

Every institution has a culture that combines many elements, including mission, history, tradition, values, and rules and regulations. However, none of these elements is sufficient to define the culture—the overarching climate of the institution. It is both transmitted from generation to generation and reflective of the leadership of the board and the organization. The culture represents the heart and soul of the organization.

It has to do with issues of integrity, honesty, purpose, value systems, and fundamental respect for the client and confidentiality of that relationship. The culture, as I am defining it, drives and permeates the organizational behavior in ways that are more compelling than just a written code of conduct or rules and regulations.

While the culture may not be found in a specific paragraph in the agency's charter, it is a powerful force that creates a sense of the organization's importance and the expected behavior of those who are a part of it. We live in a world where competition, envy, and jealousy are often the rule rather than the exception. A culture that fosters teambuilding, respect, openness, and self-expression is counterpoint to that world. Often when professionals speak to one another about what makes a good agency as opposed to a marginal or bad one it is the culture that defines their judgment, not the official agency brochure, personnel practices manual, or website.

There are many examples of how the culture influences behavior. One involves a prominent CEO who was asked, "How can your organization govern the behavior of employees when the workplaces are far removed from the administrative hub and where oversight is difficult?" The CEO responded, "It's hard, but we do not compensate for this difficulty by installing a system of cameras or snoopervisors. What we have is a strong value system that speaks to what we believe in, what we stand for, and what our honor and merit system prescribes." Of course, the culture is not foolproof and cannot assure that wrongdoing or deviation do not occur, but when it is strong and infused with professional and humanistic values, it will be influenced positively. When the values of the culture become fully integrated, then it is akin to the honor system at a college or university. When the code or culture is violated, the entire team (employees) feels the weight of the

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wrongdoing and often imposes its own sanctions or recommends specific action to be taken. The informal system is at times the best barometer to measure how well the culture has been disseminated.

In specific terms, the culture of a not-for-profit should instruct employees that gossip in the workplace is not tolerated, breaking of confidentiality is not acceptable, and comments about a person's race, nationality, ethnicity, sexual orientation, or physical appearance will have no place in the institution.

The culture starts at the top and needs to be reinforced right through the agency's ranks at all levels. The culture needs to be lived, not just spoken of, and must be adhered to, administered, and enforced throughout the organization, not just left to the human resources department. The culture is sustained in staff meetings, agency newsletters and bulletins, the tone of the website, and the physical appearance of the workplace, where the atmosphere conveys a message of dignity and respect for all. The culture should never be taken for granted and must receive horizontal support throughout all departments of the organization, including the agency's board, CEO, and supervisory structure.

Role of the Board

In a later chapter I will discuss the makeup of the governing board, the relationship of the board to the chief executive, and the board's responsibilities (legal and policy) and their proper role and function. For purposes of this chapter, it is important to note that not only is the agency's very existence dependent on a well-functioning board, but the policies and direction of the board greatly affect and influence the culture of the organization. While the CEO is the primary administrator and contributes to and executes policy, the board often is the tone setter. As we know, professionals, including CEOs, are not permanent fixtures in an agency. They have mobility and often change between positions of leadership every five to eight years. The board, however, the one continuous and stable institutional mechanism, more often than not needs to be trained so that the agency's culture becomes incorporated.

In specific terms, the board, expressed through its leadership, must show respect for the agency's mission, staff, and work. This is especially the case when difficult work does not yield successful outcomes and despite best efforts does not achieve a positive result. When this occurs, the board needs to be supportive and maintain an atmosphere of understanding, not negative judgment.

Boards must recognize that much of the work of not-for-profits is akin to clinical trials and that results are often unpredictable. Try as we may, we do not yet have a formula for success. Failure in fact may be the best way for us to learn what does and doesn't work with respect to a particular problem. Whereas we strive for performance mastery and positive outcomes, we must recognize the limitations of our knowledge and practice skills. If the culture of the agency is to be sustained at a high level and if the agency is to be continually viewed in high regard, the board must play its role in adhering to and reinforcing the culture, which is central to a high level of professionalism.

As agency budgets have grown and become more difficult to sustain, and with fundraising efforts often falling short of their goals, many not-for-profits have considered establishing partnerships with other not-for-profits or merging with an agency of similar mission. Interestingly, this direction approximated the for-profit world where mergers and acquisitions almost became the order of the day. Fundraising organizations

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and clearinghouses such as The United Way encouraged organizations to share, partner, and in many cases merge as a way of reducing competition, saving money, and infusing new life into an existing organization. While some mergers make sense, boards and CEOs should look very carefully before leaping into something that may at a given moment seem attractive, particularly if a not-for-profit is struggling to meet its budget. Once a merger occurs, it is almost impossible to reverse course and the not-for-profit, its board, and its leadership will be subsumed under a different organization, culture, and style. What seemed compatible may indeed be incompatible and what appeared to be a shared vision may be more divergent than initially perceived. The best approach is to be cautious and not jump too quickly on the basis of immediacy unless it is in fact an opportunity to extend the service, reach more people, and help sustain the organization's life.

The board also has a fiduciary responsibility to carefully manage the agency's finances, particularly its reserve or endowment funds if they exist. Many older not-for-profits have accumulated endowment funds that were given by donors for specific purposes. The endowment income is often used for a designated program. Whereas the board has the legal responsibility for the management of the endowment, they also have the moral responsibility to use it in a prudent and responsible manner for the purposes stated. The relevancy of funds given years ago will no doubt need to be reassessed with respect to changes in our society and new needs that emerge. At times it is tricky to distinguish between restricted and undesignated endowment funds as determined by the donor, but it is nevertheless the responsibility of the board with the help of legal counsel to make ethical determinations with respect to the application of funds for new uses. Many universities and some community foundations have found themselves in difficult and touchy situations when they have arbitrarily applied endowment funds to programs or administrative costs without regard to the donor's original intention. The caution is again a real one; be careful, be ethical, and seek counsel.

Endowments should also be prudently managed. The not-for-profit board should carefully select investment managers who understand the nature and mission of the not-for-profit. The managers of the funds should not take undue risks and the board finance or investment committee should carefully monitor results. Investing the not-for-profit's endowment or reserve funds should not be viewed by either members of the board or the investment managers as being done in the same way as with their own personal investment portfolios. In recent years, too many endowments had a preponderance of funds in equities (stocks) rather than in a more balanced portfolio. When the market tumbled, so did their endowments, often causing the not-for-profit great budgetary hardship. If the funds had been prudently invested, the pain would have been less. Boards and fund managers should ignore the temptation to quickly make back that which was lost. The CEO should be knowledgeable about market fluctuations, should be a "governor" with respect to the use of reserves, and should help the board understand that the portfolio is an essential part of the agency's service capacity. Certainly the managers of not-for profit pension funds should invest more conservatively. These reminders are very important in helping the board take a more moderate and balanced position.

Administrative Flexibility

In recent years, many agencies have attempted to demonstrate flexibility with respect to employees by establishing work-at-home child-care arrangements and special compensation for weekend or evening assignments. Many of these arrangements are supportive of staff needs and demonstrate a work atmosphere that encourages employee stability and a high level of performance. Technology has allowed us to make arrangements for employees to work at home. For those whose jobs require field visits, traveling directly from their homes saves precious time from having to report to the office at either the beginning or the end of the workday. However, there is one note of caution: Special arrangements should be instituted in ways that are consistent, fair, and team building, and that in no way overburden coworkers who do not enjoy these special flextime arrangements. Some not-for-profits, believing that flexibility serves the agency well, have found that it actually created a poorer workplace environment and a competitive atmosphere where one did not exist before.

Summary

- Officials of not-for-profits, both staff and board, are often unaware of the organization's history, roots, and mission.
- Greater clarity needs to exist with respect to the structure of the organization's boards of trustees, selection process for board members, and the role of the nominating committee, in addition to a conflict-of-interest statement for board members and a code of conduct.
- Many new regulations governing charitable institutions similar to Sarbanes-Oxley, while not yet applicable to not-for-profits, need to be better understood.
- Board members have become increasingly concerned about their responsibilities, obligations, and culpability with respect to the organization.

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- Various government agencies that fund programs run by not-for-profits periodically review agency minutes to determine whether the board is knowledgeable and informed about the program being funded.
- Board members should have performance reviews that include attendance at meetings, participation on board committees, and levels of contribution.
- Many not-for-profit organizations are now rated online by the Better Business Bureau and CharityNavigator.com. The ratings include administrative and overhead costs related to overall program budget.
- Not-for-profits should establish a "culture of work" that comes from the top and is reinforced on all levels throughout the organization.
- The human resources department, while responding to employee needs, is nevertheless an integral part of the organization's management structure.
- Failure is not to be feared, but understood as part of the learning process, much as are clinical trials in medical facilities.
- Boards and organizations should exercise caution before establishing mergers and partnerships to assure compatibility of mission and culture.
- The board and the executive should manage agency budgets and endowments prudently and with great care for future needs.