BOARD GOVERANCE ISSUES WITH NOT-FOR-PROFIT ORGANIZATIONS: KNOWLEDGE OF FINACIAL STATEMENTS AND ASSURANCE RECEIVED

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Cape Breton not-for-profits are trying to find what amount of adherence to the guidance contained in the Sarbanes-Oxley Act of 2002 is necessary to ensure their organizations are accountable and transparent to their stakeholders. I will explore what financial reports are presented to the boards and the assurance levels received on the annual financial statements as it pertains to good governance by Cape Breton not-for profits. Accordingly I will compare them to international organizations in order to illustrate what is done and what should be best practice.

Introduction

This paper will explore two of the present governance and legal issues that are being faced by Cape Breton Not-For- Profit's and their board members as they evolve from the original guidance contained in the Sarbanes-Oxley Act of 2002 and proceed down a more business like path in the future. The two issues are: what financial reports are presented to the boards and the assurance levels received on the annual financial statements. Both of these issues lead to the governance of an organization and how it is steered to fulfill their goals and objectives in both the present and the future.

Board members knowledge of financial accounting as it pertains to what financial reports are presented to the boards and their content as well as the assurance levels received on the annual financial statements were selected since they are specifically designed to provide financial tools by which management's performance can be measured and evaluated from both an economical and outcome point of view. Accordingly, it is essential for Board members to have the necessary financial accounting skills to properly analyze the financial statements and understand the assurances received. As Not-For- Profit's proceed down a more business like path in the future they must be productive in meeting the external competition and challenges that are facing in an ever growing business environment.

Background

Prior to the Sarbanes-Oxley Act (SOX) in Canada a Panel on Accountability and Governance was formed to aid the not-for-profit sector in responding to the challenges of the day. The panel issued its final report: *"Building on Strength: Improving Governance and Accountability in Canada's Voluntary Sector" (Broadbent Report)* in February 1999. "It recognized the strength of the sector and emphasized the responsibility of individual voluntary organizations for good internal governance." (Gill 2001)It included a reference to the financial reporting issues prevalent at the time.

Then in 2002 the United States of America (USA) put into legislation the Sarbanes-Oxley Act (SOX). This Act was legislated to protect shareholders and the general public from misrepresentations and fraudulent acts as in the highly publicized collapses of Enron, Tyco and WorldCom. The Act is not a set of best practices but provides guidance in particular with respect to: auditor independence; corporate governance and responsibility measures and expanded financial reporting requirements. Not-for-profit entities are not immune to such situations. Accordingly a not-for-profit board should be proactive and ensure the promotion of due diligence in applying good governance policies rather than be a reactive board that sits back and waits to be legislated. Accounting professionals believed that although this legislation was enacted to stop questionable financial reporting and business practices for public profit orientated entities, that the not-for-profit sector would adopt these guidelines.

In the early years, knowledge of the act was widespread, however, adoption was not. In a 2003 Board Governance Survey of over 300 not-for-profits organizations in the USA conducted by Grant Thornton LLP in Chicago fewer than 40% of the population surveyed actually had meetings with their boards regarding the implications of Sarbanes-Oxley Act on their financial reporting and governance issues. Bob Leavy, National Partner of Grant Thornton's Not-For-Profit Industry Practice stated: "Organizations that adopt similar policies to those that public companies are required to – such as ensuring that a financial expert sits on their board's audit committee – could benefit in terms of positive reaction from donors and funders as well as prospective board members. Bottom line, organizations operating in any community that depends upon the approval of the public to succeed cannot afford to overlook the implications that heightened scrutiny demands; institutional trust must be upheld." (Grant Thornton, 2003)

Institutional trust is earned and maintained by good governance policies issued from the organizations board of directors and maintaining high standards of financial reporting. The Board's primary responsibility to fulfill the organization's mission and vision statements; to safeguard the organizations resources and to manage them effectively and efficiently by allocating the proper financial resources and directing its human resources to fulfill it stated goals and objectives. Accordingly, the board of directors owes a duty of care (due diligence) to the stakeholders and can no longer just monitor the organization. This is supported in a 2004 paper by the Assembly of British Columbia Arts Councils where they stated:"Not-for-profit boards are responsible for the stewardship of the organization. Their role is to guard the mission of the organization and maintain high standards of accountability. Earning and maintaining the public trust is a key indicator that the board has fulfilled its governance role. Good governance is critical to ensuring that nonprofit organizations are effective and able to fully maximize their resources.” (Assembly of British Columbia Arts Council, 2006)

“Canada reportedly has the second largest volunteer sector in the world, and its NPO’s have been referred to as the “cornerstones” of Canadian communities. Canadian NPO’s are diverse in their origins, structures and objectives.” (Beyond Numbers 2009) That being the case, where do not-for-profits turn in Canada for guidance to promote good governance and financial reporting that leads to organizational accountability and transparency in light of the present options?

It became evident at a not-for-profit seminar held for board members at Cape Breton University in 2007 and 2008, that that there is no corresponding legislation to SOX in Canada. In addition, although they would not have to comply with SOX they would like to apply its guidance to their organizations. While numerous paper and research has been done in the USA very little comprehensive data is available to assist Canadian organizations. At present, all Canadian not-for-profit organizations must adhere to the standards contained in the accounting sections of the CICA Handbook. Given the limited resources of most organizations, it tends to be onerous on them to keep up with and apply the new standards of reporting imposed on them by generally accepted accounting principles in the CICA Handbook; outside funding agencies and the government. Globally, our economy is intertwined with the rest of the world and rapidly responds to international events, especially those of the USA. To that end I will explore the two issues relating to good governance by Cape Breton not-for profits and compare them to organizations internationally in the USA using the information contained in the Grant Thornton LLP Surveys as benchmarks in order to illustrate where they need improvement and conclude with a recommended best practice.

Methodology

To explore board member’s knowledge of financial accounting as it pertains to what financial reports are presented to the boards and their content as well as what assurance levels received on the annual financial statements were selected since they are specifically designed to provide financial tools by which management’s performance can be measured and evaluated from both an economical and outcome point of view. Accordingly, as indicated in the original guidance contained in the Sarbanes-Oxley Act of 2002, it is essential for Board members to have the necessary financial accounting skills to properly analyze the financial statements and understand the assurances their organizations receive. Both of these issues lead to the governance of an organization and how it is steered to fulfill their goals and objectives in both the present and the future. In addition, I will compare them internationally to not-for-profit organizations in the USA.

I have examined the Sarbanes-Oxley Act of 2002 and have drawn on literature and websites from both the profit and not-for-profit worlds. The profit world has been included given that was what SOX was originally created to provide guidance for and I have included sections of the Canadian Institute of Charted Accountant’s (CICA) Handbook and the International Financial Reporting Standards (IFRS).

In addition, to recognize the global environment that our not-for-profits are in I have reviewed articles; surveys and reports from around the world as they pertain to financial reporting issues and SOX. The most notable literature would be from the United States of America with supplementary literature from Ireland; United Kingdom and Australia.

This paper also draws on the ongoing research by the author. In particular a local survey which was sent to over 300 not-for-profits in Cape Breton with a response rate of greater than 10% to solicit information on financial reporting practices and the skill set of board members and their issues with follow up interviews done at not-for-profit seminars in 2007 and 2008 held at Cape Breton University. The organizations surveyed ranged in size from revenues of $100,000 to $1,500,000 with an employee base from one to twelve full time positions. The 36 completed surveys with follow ups allowed me to draw a comparison between Cape Breton not-for-profit board practices and internationally to not-for-profits in the USA.

As discussed in the introduction, I have selected the board member's knowledge of financial accounting as it pertains to what financial reports are presented to the boards and their content as well as the assurance levels received on the annual financial statements to determine what is best for Cape Breton Not-For- Profits for this paper. These were selected given the importance of the organization's sustainability and their need to have and effective and efficient board of directors. While the comparison of not-for-profit boards of different financial size is simplistic, it allows us to make the comparison and draw out a best practice for smaller not-for profit firms.

Issues

Organizations and board members in many cases don't understand why good governance matters, let alone understand that good governance allows them to achieve their organizational goals. In particular that financial reporting and its analysis are integral to good governance. There is no shortage of issues that lead to bad governance from board members, but what helps make them good members and make the link between good governance and meeting the goals and objectives of the organization. For example, the majority of the public including board members believe the financial statements are the responsibility of the outside accounting firm. In fact, the financial statements are the responsibility of management and the outside accounting firm reports on the conformity to Generally Accepted Accounting Principles (GAAP) from the CICA Handbook.

In section 1000 (Financial Statement Concepts) and 4400 (Not-for-profit Organizations) of the CICA Handbook: "Financial statements include a statement of financial position (balance sheet); statement of operations (income statement); statement of changes in net assets and a statement of cash flows." These will vary with the size of the organization and the assurance received. The three types of assurance reports that can be received from an independent outside accounting firm are an audit; review and compilation. They provide different levels of assurance and therefore are at different costs to the not-for-profit. An audit is a review based on generally accepted auditing standards (GAAS) of the financial statements; internal control system and support documentation to report an opinion "whether the statements present fairly the financial information in all material respects in accordance with generally accepted accounting principles", (CICA Handbook) which is the most costly. A review report assesses "whether the information being reported upon is plausible within the framework", (CICA Handbook) and provides negative assurance that the information in all material respects in accordance with GAAP, which is less costly than an audit. A compilation simply puts the information in a readable form and provides no assurance on the financial information and is the least costly.

Board members must be knowledgeable in financial accounting; financial statement presentation and the different types of assurance you can receive from the independent accounting firms. Do they understand what annual statements are presented and what level of assurance they have and/or require and how does it compare to the interim reports presented at the board meetings?

These questions were posed to participants at Not-for-profit seminars held at Cape Breton University in 2007 and 2008 with follow ups done from 2007 - 2009. At present, all Canadian not-for-profit organizations must adhere to the standards contained in the accounting sections of the CICA Handbook. Most board members from the 36 completed surveys said they read and understood the annual financial statements (92%) and all knew what type of assurance they received from the outside accounting firm (Audit 40%, Review 30% and Compilation 30%). This is a very positive result given that a 2006 survey indicated that "…50% or more of their board members have the ability to read and understand financial statements." They all expressed the fact that cost was the major contributor to determining what type of engagement they solicited from the outside accounting firm followed by covenants imposed by financial institutions and government. Greater demands of the funders and donors as well as a need to be accountable and transparent will push most organization towards an audit or at a minimum a review. These restrictions will impose a further drain on the financial and human resources of the small not-for-profit organizations.

Of those audited 50% had audit committees in place compared to 65% in the USA (Grant Thornton, 2009). Interestingly during my literature review I noted that this was 40% in Ireland (Price Waterhouse Cooper, 2003). The USA percentages have been consistent since their 2005 survey. In this connection, each Cape Breton not-for-profit audit committee had a professional accountant; another business executive and someone with multiple board experience serving on them versus USA not-for-profits having these people on their audit committee's at75-80%. This was higher than I expected given the fact that in my opinion the professional communities in small areas such as in Cape Breton are being tapped out and the individuals are reaching the burn out stage. Accordingly, they are reluctant to commit since it is harder to backfill their positions on small local not-for-profit boards. The healthier boards are the ones that have a mixture of older members for continuity and newer members to add vitality. Without such a mixture of skilled board members these organizations are not sustainable in the future.

Information pertaining to the interim reporting and budgeting that was also retrieved in 36 follow-up interviews in 2009. It indicated that management reported financial information to the board of directors as follows: 84% on a monthly basis, 8% quarterly and 8% semi annually. The financial statements presented to the board were the statement of operations (income statement) 92% of the time; the statement of financial position (balance sheet) 70% of the time; the statement of changes in net assets 39% of the time and the statement of cash flows at 44%. None of the organizations had complete financial statements presented except for at yearend. In this connection, although annual budgets were prepared 75% of the time, they were not analyzed until the yearend figures were produced and variances were reported at that time. Of those whom had annual budgets, only 11% prepared monthly variance analysis for board meetings. In half the cases the executive director was the presenter of the interim financial information and provided limited support documentation. In my opinion, this is unacceptable considering the overall risks associated with being a board member in today's litigious world that director's liability insurance will not cover.

Good Governance indicates that each board member must know the financial direction the organization is going (the budget) given that they are board approved and are responsible in theory for the strategic direction of the organization. You must evaluate from a strategic point of view, where you are and where you want to be in order to stay in business. The alignment of strategic goals and budgets for not-for-profits must be at the top of the board's priority since organizations can take many varied paths along the road. Accordingly, the budgets must be revised periodically in response to the ever changing political and economical climates that influences them. There is no cookie sheet approach to budgeting and/or financial presentations that fits all organizations; one size does not fit all. This leads to the question of what is the skill sets required to achieve the goals and objectives of the organization in this regard.

It is observed that the demographics of the Grant Thornton surveys would be similar to the not-for-profit demographics in Canada if we take into account that in terms of size 93% of not-forprofit organizations in Canada have revenues of less than $1 million. "Hospital and universities and colleges represent less than one percent (1%) of all organizations but account for thirty-three percent (33%) of all revenues." (CICA, 2009) The local survey's had two participants from the hospital and university setting which represents less than ten percent (10%) of the surveys which would lead to the split in size.

What does this hold for the small not-for-profit boards given the guidelines from SOX back in 2002; the emergence of International Financial Reporting Standards in the near future combined with the fact that not-for-profit are still waiting to find out where their home is in Canadian GAAP. That is under the private sector or under the public sector of accounting in the Handbook.

Concluding Remarks

As shown one size does not fit all, the diversity of the Not-for-profit sector in Canada is too wide. Many not-for-profits believe to build a cohesive membership you look for people with similar backgrounds and social standing. However, homogeneous teams are often not well suited for complex tasks or problems that require creative solutions as is the case in Community Development or Not-for-profit settings. In these cases a team with diverse skill sets and social standing are needed in order for the organization to be in their business in the long term. Accordingly there is a trade off when selecting from the nominees between homogeneous and heterogeneous dynamics.

"Board members may be supportive and passionate about the agency and its mission but not well-versed in financial statements, cash flows and internal controls." (Stone Bridge, 2007) This partially answers why board members think they can read and understand the financial statements and would know the differences between the three types of assurances, but would not be able to articulate them completely. "Not-for-profit organizations have stewardship obligations to contributors, members, lenders, and/or other users of their financial statements, including the public at large." (Beyond Numbers 2009). These pressures combined with a board's proactive behavior and self-regulation will always be a more powerful tool than compulsory compliance under GAAP. Cape Breton boards have strived for greater disclosure and transparency to be accountable to all stakeholders. Some additional training with regards to reading financial reports and budgeting should be provided, especially in light of the upcoming changes in reporting standards from the CICA and IFRS expected to be enforced in 2010 and 2011, respectively. This should improve the relevance and reliability of the financial statements and improve the transparency and accountability of the organization.

I believe this should start with ensuring that board members are knowledgeable in financial accounting; budgeting and the different types of assurance you can receive from the independent accounting firms. This is imperative, given the fact that the board members must approve the content of the financial statements; the budgets and the presentation of the financial reports most notably the financial statements and in their analysis. Both the financial statements and budget must provide the board with the necessary information to make informed decisions about the selection of programs and the allocation of its scarce financial and human resources. During the budgeting process we must strive to keep board members focused on the forest and not the trees. We must get them to ask the right questions. Does the budget line up with the organizations goal and objectives? What assumptions were made in order to prepare the budget? Who is responsible to monitor the budget and report the outcome to the board? What are the organizations policies regarding these issues?

Monthly financial reporting is the best way to provide the board with the necessary information to make those informed business decisions. In my opinion the monthly reporting should at a minimum include a statement of operations (income statement) and a statement of financial position (balance sheet). In addition at minimum annual budgets must be prepared with monthly budgets being the preferable option in order to see the strategic direction of the organization is heading in the near future and those should then be compared to the actual results. All variances from those budgeted should be analyzed and the results reported to the board. Accordingly, the budgets then can be revised periodically in response to the ever changing political and economical climates that influences them.

For those that are audited (at present 40% of those surveyed) the creation of a strong audit committee and/or enhancement of present audit committee will lead to the best governance over the external and compliance reporting as indicated by SOX and GAAP. The fact that they all had a professional accountant; another business executive and someone with multiple board experience serving on their audit committee was extraordinary. However, Cape Breton not-for-profits should strive to exceed the number of audited organizations with audit committees in the USA of 65%. In addition, consideration to rotating the audit firm every five years, not-forprofits should ensure that non-audit procedures are not carried out by the auditing firm are encouraged under SOX.

In this connection, to reduce board risk organizations should put together a new board member orientation package that would incorporate the above as well as include such things as the organizations vision and mission statement; articles of association; by laws; board chart and organization chart and a history of the organization. The ongoing education of its members starting with the orientation package will reduce the overall risks associated with being a board member in today’s litigious world that director’s liability insurance will not cover.

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