CAPLAW

Community Action Program Legal Services, Inc.

CAPLAW Governance Case Studies

Prepared by

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Introduction

There has been a great deal of discussion during the last five years over the role that boards should play in overseeing nonprofits and their activities. Some argue that too many boards are passive, failing to provide adequate oversight over scarce resources. These critics can point to all too many board failures that have resulted in fraud and mismanagement. Others are quick to respond that many boards are filled with volunteers, who want to do right by their nonprofits, but who face time constraints, limited knowledge, and other limitations.

Many who serve on boards aren't even clear as to what their role is. Should they come to the monthly meetings, enjoy the coffee and doughnuts, and serve as cheerleaders? Or, are they supposed to take an active role in managing the nonprofit, possibly coming in on Saturday to clean the office, reconcile the checkbook, or stack cans of food in a warehouse? Many know that they should be asking questions at board meetings, but what questions?

Some board members who have taken their roles seriously have asked for training or board orientation. That certainly is a start, but traditionally board training has relied heavily on a lecture format. That is a worthwhile start, particularly in outlining legal, accounting, and financial issues. Lecture is a tried and true format for imparting basic information.

Unfortunately, lectures cannot provide board members with a sense of the hard choices that boards often face. The 11 case studies that follow are designed to provide board members and nonprofit managers with a better sense of the issues that boards should be focused on and what it means to grapple with them. The boards in most of these cases failed miserably in defining and carrying out their oversight function. Sadly, those failures led to agencies closing, cuts in services, people losing their jobs, and skepticism by legislators and grantmakers over whether programs should be funded.

Most people who volunteer to serve on boards certainly don't do so because they want to promote failure. Just the opposite: They want to make a constructive contribution. The case studies are offered as teaching tool that will promote positive oversight and results. They aren't a substitute for hands-on experience, but they should come closer than a lecture in providing board members and nonprofit managers with a sense of the discussion that should be taking place during board meetings.

Media Accounts

Each case is based on media accounts of a Community Action Agency or similar social service agency that experienced problems rooted in governance failures. In some cases, the media accounts have been supplemented with investigatory audits and reports prepared by government agencies and consultants.

Identities

Identifying information is provided if the CAA or other nonprofit no longer exists. This permits full citation to source material. In the case of agencies that still exist, fictitious names

have been substituted for actual names. In all cases, the intention is not to criticize agencies or individuals, but to use the mistakes that others have made as teaching opportunities.

Provocative Questions

These cases studies were prepared by Jack B. Siegel of Charity Governance Consulting LLC. After the facts are set out, each case study asks a number of questions intended for discussion and then provides a brief suggested solution for the case. Some of the questions are intended to be provocative in order to generate a meaningful discussion. No inferences should be drawn from those questions as to the views of Jack or CAPLAW. The suggested solutions represent one viewpoint, but they are not necessarily the best or the only way to view the case.

Discussion

There are 11 cases studies in this series. Those leading the session can use all the cases, or just a few. Whatever the choice, it should permit the participants to engage in a lengthy discussion of each selected case. This exercise will succeed only if the participants are permitted to grapple with the issues posed by the cases through group discussion and debate. That discussion and debate most likely will reveal a divergence of opinion, demonstrating that there is not one right or easy answer to the questions posed.

Background Material

The case studies focus on business, governance, and personnel issues. Lurking in the background are legal considerations. To avoid overpowering the cases with legal rules and commentary, significant portions of the legal discussion has been placed in a document labeled "Background Material". Each case makes reference to relevant portion of the background material. The background material also includes references to useful links and resources.

About the Author

Jack B. Siegel, Esq., CPA, provides consulting services to nonprofits through Charity Governance Consulting LLC. He focuses on board and staff training, governance manuals, financial management, record retention, and special projects. He is the author of *A Desktop Guide for Nonprofit Directors, Officers, and Advisors: Avoiding Trouble While Doing Good* (Wiley 2006), a comprehensive 744-page book addressing the legal, financial, tax, regulatory, and governance issues facing nonprofit boards and senior officers. He also maintains a highly regarded blog, accessible at http://charitygovernance.com. Mr. Siegel holds an LL.M. in taxation from New York University and a master's of management from Northwestern University. He can be contacted at 773.325.2124 or by e-mail at jbsiegel@charitygovernance.com.

About CAPLAW

CAPLAW is a nonprofit membership organization dedicated to providing the legal resources necessary to sustain and strengthen the national Community Action Agency (CAA) network. For over 40 years, since they were first created by the Economic Opportunity Act of 1964, CAAs have been fighting poverty, helping individuals become self-sufficient, building communities, and changing lives. Nationwide, approximately 1,000 CAAs leverage almost $10 billion in total funding, and provide a multitude of services, including job training, Head Start, economic development, energy assistance, and housing.

Through its in-house legal staff and a network of private attorneys, CAPLAW provides legal consultations, training, and publications on a wide variety of legal and management topics. This assistance enables CAAs to operate legally sound organizations and to promote the effective participation of low-income people in the planning and delivery of CAA programs and services, thereby enhancing CAAs' ability to provide the nation's poor with opportunities to improve their quality of life and to achieve their full potential.

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Background Information and Resources for the CAPLAW Governance Case Studies

I. Background Information — Setting Compensation

The Office of Head Start, the IRS, and state regulators are all interested in compensation levels and the process by which they are determined.

A. Head Start Limitations

Section 653 of the Head Start Act limits the compensation of staff. The language precludes use of any Federal funds to pay any part of the compensation of an individual employed by a Head Start grantee whose compensation exceeds the rate payable for level II of the Executive Schedule, which is currently $172,200 (effective January 2008).

1. COMPENSATION DEFINED

Compensation is specifically defined in Section 653 to include "salaries, bonuses, periodic payments, severance pay, the value of any vacation time, the value of a compensatory or paid leave benefit not [explicitly] excluded and the fair market value of any employee perquisite or benefit not [explicitly] excluded." Explicitly excluded from counting as compensation is "any Head Start agency expenditure for a health, medical, life insurance, disability, retirement or any other employee welfare or pension benefit."

2. THE CAP

The cap precludes any Federal funds being used to pay an individual whose compensation exceeds the cap, not just Head Start grant funds. Moreover, unlike previous policy in which grant funds could be used to pay up to the cap, but not for any compensation that exceeded the cap, the new statutory requirement precludes any funds being used to pay any part of an individual's compensation, if that individual's compensation exceeds the cap. For example, previously if an individual who worked full time for Head Start had a 2008 compensation level of $180,000, that grantee would have been authorized to charge up to $172,200 of that compensation to the Head Start grant, finding $7,800 in non-grant funds to fully pay that individual.

The new requirement will not permit any Head Start (or other Federal) funds, to be used to pay any part of that individual's compensation. That is, all $180,000 would have to come from non-federal sources or the individual's compensation would need to be reduced. It is important to note that this cap applies to all staff who receive any part of their compensation from Head Start (or other federal funding sources), including those whose salaries are part of an indirect cost pool.

3. EFFECTIVE DATE

The Office of Head Start recognizes that some grantees will need to make adjustments to their personnel policies and/or will need to have their indirect cost rate redetermined by their cognizant federal agency. In order to give these agencies a reasonable period of time to make such changes, implementation of the compensation cap will be effective for all Head Start grantees beginning with the awarding of their FY 2009 annual grant award.

4. AUTHORITY

The foregoing discussion is based on a Program Information memorandum, ACF-PI-HS-08-03, issued on May 12, 2008 by the U.S. Department of Health and Human Services (Office of Head Start in the Administration for Children and Families).

B. Setting Compensation

Although there may be slight differences between how the IRS and state regulators judge the procedures used to set compensation and its reasonableness, in practice, the same procedures should suffice for both state regulatory and tax purposes. These procedures include: (i) the use of meaningful comparables; (ii) linkage of pay to performance; (iii) the approval of the compensation package by an independent board of directors (or an authorized committee thereof); and (iv) the contemporaneous documentation of the decision and the basis for it.

C. The Intermediate Sanctions

The intermediate sanctions are a comprehensive set of tax rules designed to assure that compensation paid to key employees and other insiders reflects market-rate compensation. If the IRS determines that the compensation is excessive, it can force the recipient to return the excess to the exempt organization and assess an excise tax equal to 25% of the excess on the recipient.

The centerpiece of this regime is a rebuttable presumption that compensation is reasonable if certain procedures are adhered to when setting the compensation. Specifically, the organization must demonstrate that (i) the compensation arrangement was approved in advance by the board of directors (or a committee thereof); (ii) such board (or committee) was comprised entirely of individuals who do not have conflicts of interest; (iii) such board (or committee) obtained in advance and relied on appropriate data as to comparability of the compensation arrangement; and (iv) such board (or committee) adequately documented the basis for its determination concurrently with the decision.

The rules contemplate otherwise conflicted individuals recusing themselves from the process. A rebuttable presumption does not mean that the IRS cannot question the reasonableness of the compensation. But if the IRS does question compensation, it has the burden of proving the compensation is unreasonable.

1. COMPLEX

Unfortunately, the intermediate sanctions are a complex set of rules. This complexity is attributable to the fact that the rules not only apply to social service agencies, but to large nonprofit hospitals, cultural institutions, and colleges and universities. Smaller social service agencies will want to work with their legal counsel or accounting firm to assure that the rebuttable presumption is available. Competent advisors should be able to provide practical advice without running up large professional fees.

2. DISQUALIFIED PERSONS

The intermediate sanctions only apply to compensation arrangements between the organization and individuals who are referred to as “disqualified persons”. Disqualified persons include voting members of the board, the president, chief executive officer, chief operating officer, the treasurer, the chief financial officer, and other persons who have substantial influence over the affairs of the organization.

An employee who earns less than $105,000 during the 2008 tax year (this number is indexed for inflation and adjusted annually) generally will not be considered a disqualified person if the employee is not a voting member of the board or one of the officers named earlier. There

are related-party rules which can cause someone otherwise not considered to be a disqualified person to be treated as one because of family membership or beneficial ownership interests.

3. THE INCENTIVES

Although people normally think of the intermediate sanctions applying to tax-exempt entities, the operation of these rules has the greatest practical impact on the executive director and other highly-compensated individuals. If the IRS successfully challenges the reasonableness of the executive director's compensation package, it is the executive director who must return any excess benefit to the organization and pay the 25% penalty. Consequently, the executive director and other disqualified persons should be the ones who insist that the necessary conditions are satisfied so as to permit reliance on the rebuttable presumption.

4. COMPARABLES

In a 2006 phone forum, the IRS indicated that reasonable compensation is an amount ordinarily paid for (i) like services (ii) by like enterprises (whether taxable or tax-exempt) (iii) under like circumstances.

a) Services are considered like by examining whether the work is "hands-on" or general involvement, national or local in scope, the number of employees managed, the size of the budget or assets managed, whether the management function involves multiple functions, departments, facilities, or entities, whether the position is full- or part-time, and whether the service is in multiple capacities or for a group of related entities.

b) Enterprises are considered alike by examining budget, revenues, number of employees, and persons served, whether the same type of business is involved (pre-school vs. university), and whether there is a mix of non-profit and for-profit entities. Additionally, the entities must be competing for the same pool of talent.

c) To ascertain whether the circumstances surrounding two nonprofits are similar, the analysis should ascertain whether the nonprofits are providing the services in an urban or rural environment, in similar size geographic areas, and in areas with the same costs of living. To be comparable, the compensation must consist of a similar mix of compensation items, and include all compensation items (whether taxable or not).

d) Organizations should consider reviewing Form 990s for comparable organizations to help them develop compensation comparables. Organizations are required to disclose compensation information for their five-highest paid employees, as well as for key employees, officers, and selected others. The redesigned Form 990, which will be first used for the 2008 tax year, requires more detailed compensation disclosures. Organizations can obtain copies of the three most recent Form 990s for most charitable and other tax-exempt organizations at http://www.guidestar.org

D. Best Practices

1. USE A COMPENSATION COMMITTEE

Developing a compensation package is a time-consuming process. The board can best preserve valuable meeting time by delegating to a compensation committee the task of arriving at an appropriate compensation package for the executive director and any other designated

employees. Once the committee has developed a recommendation, it should then present the recommendation to the full board for review and approval.

2. USE A TALLY SHEET

Each member of the board should understand the form and the amount of compensation being paid to the executive director and other key employees. A one- or two-page tally sheet should be distributed to each board member before a compensation package is approved. It should list and succinctly value each item in the compensation package.

3. ASSURE BOARD INDEPENDENCE

Those approving the executive director's compensation should be independent. Board members should not be related to the executive director or have a financial relationship with the organization that is controlled by the executive director or someone who reports to the executive director. For example, the board may have a lawyer as a member. Arguably, that lawyer is not independent if her law firm provides legal services to the organization and the executive director is the one who selects the law firm. Unfortunately, for purposes of the intermediate sanctions, the IRS has been less than forthcoming in defining the outer limits of independence.

4. LINK PAY TO PERFORMANCE

Compensation levels and bonuses should always be linked to performance. Setting compensation goes hand in hand with evaluating performance and setting goals. Boards should avoid routinely ratcheting up compensation levels simply because of the passage of another year. In other words, pay for performance, not seniority.

5. AVOID THE LAKE WOBEGONE EFFECT

Garrison Keillor has famously said that the residents of his fictional Lake Wobegone boast that all their children are above average. Too many nonprofits believe the same of their "average" executive director. When relying on comparables, many organizations simply place their executive director at the 70th percentile. There are legitimate reasons why an executive director should be paid at a rate that places him or her below the 50th percentile. One is inexperience. Before paying an executive director at the 70th or 80th percentile, the organization should be able to demonstrate through concrete evidence that the executive director performs better than most other executive directors working for comparable organizations.

6. RELY ON MEANINGFUL COMPARABLES

The IRS wants to see organizations rely on comparables when setting compensation. Those comparables must be meaningful. That means making sure that the organizations used for comparison are similar to the organization relying on the comparables. To be considered comparable, an organization should conduct similar programs, be relatively equal in size, and have a similar workforce. It certainly is permissible—and may even be enlightening—to include outliers in the data set, but the people relying on the comparables must analyze all the data, recognizing the differences and explaining why those differences may or may not be relevant. In sum, compare apples to apples, but looking at oranges is certainly permissible as a part of an effort to gain a deeper perspective.

7. AVOID BUILT-IN CONFLICTS WHEN USING A COMPENSATION CONSULTANT

Some organizations will use a consultant to help them develop compensation packages for

executive officers. This is appropriate, but only if the consultant is independent. The board should not rely on a compensation consultant who is already performing consulting work for the organization, particularly if the executive director or other key employee retains the consultant. In that situation, the consultant has a built-in incentive to protect the benefits, human resources, and actuarial work performed for the organization by recommending higher than appropriate compensation for the executive director or other key employees. One-stop shopping may at first appear to be efficient, but it could prove costly and should therefore be avoided.

E. Resources

The following resources may prove useful to anyone who is looking for more detailed information.

1. Letter from the Massachusetts Attorney General to Citi Performing Arts Center, http://www.charitygovernance.com/charity_governance/files/2007_12_05_citicenter_attachment1.pdf.

   This letter certainly is not the final word, nor should it be viewed as a legal requirement mandating a specific set of procedures. The letter was the culminating step in an investigation by the Massachusetts Attorney General into whether an arts group's executive director was overcompensated. The analysis provides an excellent example of how any board should approach the determination of compensation.

2. House Committee on Oversight and Government Reform, EXECUTIVE PAY: CONFLICTS OF INTEREST AMONG COMPENSATION CONSULTANTS (Majority Staff Report, December 2007), available at http://oversight.house.gov/documents/20071205100928.pdf

3. Brian H. Vogel and Charles W. Quatt, DOLLARS AND SENSE: THE NONPROFIT BOARD'S GUIDE TO DETERMINING EXECUTIVE COMPENSATION (BoardSource 2005)

4. Executive Compensation: Audio version of teleconference seminar, published by BoardSource and available at http://www.boardsource.org

5. The Intermediate Sanctions: Title 26 Code of Federal Regulations, Treasury Regulation Section 53.4958.

6. Bruce Hopkins, THE LAW OF INTERMEDIATE SANCTIONS: A GUIDE FOR NONPROFITS (Wiley 2003). This book is out of print, but used copies can probably be found on the Web.

7. IRS Continuing Education Materials

   a) "Automatic" Excess Benefit Transactions under IRC 4958, http://www.irs.gov/pub/irs-tege/eotopice04.pdf
   b) Intermediate Sanctions (IRC 4958) Update, http://www.irs.gov/pub/irs-tege/eotopice03.pdf
   c) Section 4958 Update, http://www.irs.gov/pub/irs-tege/eotopicb00.pdf

8. IRS Executive Compensation Initiative—A 2007 report on how the IRS is applying the intermediate sanctions in the field, http://www.irs.gov/charities/charitable/article/0,,id=169164,00.html

9. Organizations seeking comparables may want to consider using the Economic Research Institution's Nonprofit Compensation database, available through subscription at http://www.erieri.com/index.cfm?fuseaction=ERICA.Main&trkid=479-161. The database is taken from the IRS Form 990 and 990EZ. The annual subscription rate for the professional edition is currently listed as $489. Demo software can be requested.

II. Background Information — Incentive Compensation

Incentive compensation raises issues under both federal tax law and the rules governing federal and CSBG grants.

A. Federal Tax Law

The following are considerations that should be taken into account when developing any bonus or incentive compensation plan:

1. BUSINESS PURPOSE

There should be a "real and discernable business purpose" that furthers the CAA's exempt purpose (for example: motivating and reinforcing efficiency and quality of service and encouraging cost containment). The plan must not be a device to distribute profits to principals of the organization or transform the organization's principal activity into a joint venture.

2. APPROVAL BY INDEPENDENT BOARD

The plan should be established and implemented by an independent board of directors or an independent committee of the board, such as a personnel or compensation committee.

3. SAFEGUARDS

The plan should include safeguards to prevent a reduction in the charitable services the agency would otherwise provide and to prevent abuse of the plan (for example, taking steps to ensure that the agency is on track to provide all the program services it has committed to in its annual program budgets and plans before paying out bonuses and to ensure that program managers do not set aside funds for the bonus pool that should be used to provide program services).

4. REASONABLE COMPENSATION

Total compensation – including amounts paid under the plan, plus all other forms of compensation – provided to each employee should be reasonable.

5. CAP ON THE BONUS

The bonus plan should include a cap on the size of a bonus that employees may earn (e.g., a certain percentage of their regular salaries). This will help the CAA determine in advance whether the employee's total compensation is reasonable and will help in budgeting for payments under the plan.

6. OBJECTIVE STANDARDS

The bonus plan should set objective standards for judging employee performance that are linked to the agency's accomplishment of its exempt purposes. It should also reward an employee for her actual accomplishments, rather than for the overall performance of parts of the organization in which the employee does not do significant work or on which the employee's own work performance is not likely to have an impact.

7. RIGHT TO CANCEL

The plan should specify that the board may, in its sole discretion, cancel the bonus plan at any time if doing so is in the CAA's best interests and that the board may cancel or reduce potential bonus awards at the time they are scheduled to be paid if payment of the awards would be in violation of any law or regulation, would jeopardize the agency's ability to meet its obligations to funders, would jeopardize the agency's ability to carry out its tax-exempt purposes or would otherwise not be in its best interest. (The agency should discuss with its employment law attorney how to structure and operate the plan so that cancellation of the plan or cancellation or reduction of potential bonus award will not run afoul of any state law concerning the payment of wages. In particular, if the plan can be unilaterally canceled, that fact and the basis for cancellation should be spelled out in the employee handbook or other appropriate written document made available to employees.)

B. Federal Grant Law

Any incentive compensation arrangement must also be structured to comply with the requirements of OMB Circular A-122, Cost Principles for Non-Profit Organizations. Under Circular A-122, incentive compensation is an allowable cost under a federal grant to the extent that: (i) overall compensation is determined to be reasonable (this requirement is consistent with the IRS requirement that an employee's total compensation be reasonable) and (ii) the incentive compensation is paid or accrued either: (a) under an agreement entered into in good faith between the organization and the employees receiving the incentive compensation before the employees performed the services on which the incentive compensation was based or (b) pursuant to an established plan followed by the organization so consistently as to imply an agreement to make an incentive compensation payment.

C. RESOURCES

1. See I_E, above.

2. See Private Letter Ruling 200601030 (Jan. 6, 2006); IRS Information Letter 2002-0021 (Jan. 9, 2002); and General Counsel Memorandum 39674 (June 17, 1987).

3. See OMB Circular A-122, Att. B, ¶ 8.j (available online at http://www.whitehouse.gov/omb/circulars/a122/a122_2004.html, which is not codified at 2 CFR Part 230, App. B

III. Background Information — Conflicts of Interest

Many believe that conflicts of interest are easily dealt with: Just adopt a policy, make sure that interested parties recuse themselves, and prices are determined by competitive bids or evaluated using independent appraisals. Unfortunately conflicts of interests are not so easily dealt with.

A. Conflicts-of-Interest Policies

There are hundreds of conflicts-of-interest policies available on the Internet. It is tempting to just copy and adopt one of those policies. This is to be avoided. Any meaningful conflicts-of-interest policy must take into account the particular nonprofit's specific circumstances and culture. At a minimum, the board should consider:

1. WHO?

Who should the policy apply to? Officers, directors, and employees are likely candidates, but what about independent contractors, vendors, volunteers, and beneficiaries of services? And what about past employees or retired directors, or family members or related entities?

2. WHAT?

What conflicts are covered? Everybody agrees that transactions between the organization and employees should be covered, but what about

a) The local banker who is a nonprofit director if his bank agrees to make a market rate loan to the nonprofit? At first, this seems like a great idea, but what happens if the organization defaults on the loan and the banker also sits on the organization's finance committee?
b) What about the education expert who sits on the nonprofit's board and agrees to provide her advice on a particular matter for free? Price certainly isn't the issue, but doesn't this potentially provide her with the equivalent of a super-majority vote because she can manipulate the board and the action it takes by how she formulates her advice.
c) What about the architect who is the son of the board chair and who is submitting a bid for work?

3. NOTIFICATION

If a person subject to the policy becomes aware of a potential conflict, who should he notify? Should the employee notify his immediate supervisor, or should there be one person who centrally reviews all conflicts?

4. ENFORCEMENT

How is the policy enforced? Typically, under the terms of the policy, those who are covered by the policy have an affirmative duty to identify potential conflicts.

a) Should those subject to the policy be required to re-affirm it (and their compliance) once a year?
b) Should someone be charged with auditing transactions to make sure there are no conflicts?

5. PENALTIES

The policy should clearly spell out the consequences of violating the policy, particularly if violations will result in a job action such as termination or suspension. In the case of a director, is an undisclosed conflict a basis for automatic removal?

B. Duality

With the tripartite board structure, the boards of CAAs are divided between low-income community members (and people who represent such individuals), government representatives, and other interested parties. Although probably unanticipated by the architects of this structure,

this segmentation creates dual loyalties that pose potential conflicts.

1. LOW-INCOME REPRESENTATIVES

Is a low-income representative supposed to act in the best interests of low-income individuals served by the agency or in the best interests of the agency? Some people will assume the two focuses neatly dovetail, but suppose someone proposes spending $2 million on a new program that benefits low-income members of the community when the organization is already running significant deficits?

2. GOVERNMENT REPRESENTATIVES

Assume the organization's bylaws provide that the mayor is an ex-officio board member, with full voting power. Further assume that the mayor has been advised by his staff to recommend that grant money be awarded to a competing CAA or other social service agency. How should the mayor resolve the conflict resulting from his dual roles as mayor and board member? He is supposed to do what is best for both the city and the organization.

A strong case can be made that the organization's bylaws and conflicts-of-interest policy address the potential for conflicting loyalties. Wherever addressed, the policy regarding these conflicts should be established from the outset and clearly explained to all interested parties.

C. OMB Circular A-110 (Now codified as 2 CFR part 215)

The Office of Management and Budget has issued Circular A-110, Uniform Administrative Requirements for Grants and Agreements With Institutions of Higher Education, Hospitals, and Other Non-Profit Organizations. These rules generally apply to federal grants and sub-grants, including some state-administered block grants, such as CSBG grants. The federal rules require that states must "ensure that cost and accounting standards of [the OMB] apply to a recipient of [CSBG] funds" *See* 42 USC 9916(a)(1)(B).

1. CONFLICTS OF INTEREST

Paragraph 42 of Circular A-110 requires that the grant recipient maintain written standards of conduct governing the performance of its employees engaged in the award and administration of contracts. No employee, officer, or agent may participate in the selection, award, or administration of a contract supported by Federal funds if a real or apparent conflict of interest would be involved. Such a conflict arises when the employee, officer, or agent, any member of her immediate family, her partner, or an organization which employs or is about to employ any of the indicated parties, has a financial or other interest in the firm selected for an award. The officers, employees, and agents of the recipient must neither solicit nor accept gratuities, favors, or anything of monetary value from contractors or other interested parties. However, organizations may set standards for situations in which the financial interest is not substantial or the gift is an unsolicited item of nominal value. The standards of conduct must provide for disciplinary actions to be applied for violations of the rules.

2. CONTRACT AWARDS

Paragraph 43 addresses the rules that apply to an agency's expenditure of grant funds, requiring competitive bidding. The grant recipient must be alert to organizational conflicts of interest as well as noncompetitive practices among contractors that may restrict or eliminate competition. The grant recipient is further instructed that when it awards contracts, the award

is to be made to the bidder whose bid or offer is responsive to the solicitation and is most advantageous to the recipient, with price, quality and other factors considered.

D. Head Start Legislation

Section 642 of the Improving Head Start for School Readiness Act of 2007 addresses program governance, with subsection (c) focusing specifically on conflicts of interest. Under this recently enacted legislation, members of the governing body may not (i) have a financial conflict of interest with the Head Start agency (including any delegate agency); (ii) receive compensation for serving on the governing body or for providing services to the Head Start agency; or (iii) be employed, or have members of their immediate family be employed, by the Head Start agency (including any delegate agency).

Moreover, the governing body is given an affirmative duty to operate independent of staff employed by the agency. There are limited exceptions for individuals who hold a board position as a result of public election or political appointment if such position carries with it a concurrent appointment to serve as a member of a Head Start agency's governing body. In such case, the individual can receive compensation if it payable as a consequence of the election or the appointment. Additionally such person can serve despite a conflict described in (ii) or (iii) above. These rules are now codified at 42 U.S.C. §9837.

E. IRS Form 990

Beginning with the 2008 taxable year, the IRS and the public will know whether an organization has a conflicts-of-interest policy. Question 12a of Part VI of the Core Form to the recently revised Form 990 asks whether the organization has a conflicts-of-interest policy. Question 12b then asks whether officers, directors, and key employees are required to disclose annually interests that could give rise to conflicts. Finally, Question 12c asks whether the organization regularly and consistently monitors and enforces compliance of its conflicts-of-interest policy.

F. Resources

The following resources may prove useful to anyone who is looking for more detailed information.

1. Independent Sector, PRINCIPLES OF GOOD GOVERNANCE, available at http://www.nonprofitpanel.org/

2. American Law Institute, PRINCIPLES OF THE LAW OF NONPROFIT ORGANIZATIONS: TENTATIVE DRAFT NO. 1 (March 19, 2007).

3. Marion R. Fremont-Smith, GOVERNING NONPROFIT ORGANIZATIONS: FEDERAL AND STATE LAW AND REGULATION (Belknap Press 2004).

   Fremont-Smith is the dean of nonprofit governance. She served as the Assistant Attorney General and Director of the Division of Charities in Massachusetts and is a retired partner of Choate, Hall, and Stewart. The book may be more than many want, but it is what everybody needs. A soft-cover edition is scheduled for publication sometime in 2008.

4. Jack B. Siegel, A DESKTOP GUIDE FOR NONPROFIT DIRECTORS, OFFICERS, AND ADVISORS: AVOIDING TROUBLE WHILE DOING GOOD (Wiley 2006).

IV. Background Information — Whistleblowers

A. Whistleblower Policies

In an effort to open up the line of communication, every organization should give serious considerations to adopting a whistleblower policy.

1. AVAILABILITY

The policy should be available to employees, independent contractors, volunteers, vendors and service providers, and service recipients.

2. RECIPIENT

The policy should identify the person who should receive the report. Policies often direct the whistleblower to a member of the board's audit or finance committee when the concern is over financial matters. In the case of employment practices, policies often direct the whistleblower to contact HR or a member of the organization's board (possibly a member of the board's compensation committee). Every policy should specifically name the person who the report is to be directed, provide for an alternative in that person's absence, and provide contact information.

3. EARLY REPORTING

The policy should encourage early reporting of concerns.

4. METHOD

Reports are best made by telephone or in a secure written form. Potential whistleblowers should be advised to avoid inter-office routing envelopes and e-mail reports. To encourage reports, the policy should state the mechanisms that are in place to protect the whistleblower's identity. For example, whistleblowers might be notified that the whistleblower's phone number will not appear as part of a caller id system when calling a hotline (assuming that is the case). The policy should also advise the potential whistleblower not to leave details as part of voice mail messages.

5. REPORTING THRESHOLD

The policy should require that any report should be made in good faith and be based on objective facts. It should also clearly state that malicious, intentionally false, or trivial reports will not be tolerated and may result in disciplinary action. Employees should be advised that unless the circumstances warrant, they should first address their concerns with their immediate supervisor, or when appropriate, HR. The policy should provide examples of situations where it is appropriate to bypass supervisors such as when there is clear evidence of criminal activity, extensive and ongoing harassment or discrimination, or threat to life.

6. CONFIDENTIALITY

The policy should never guarantee confidentiality, but it should assure that the organization will use reasonable efforts to keep the person's identity confidential if requested. An organization can never guarantee confidentiality because investigations, discovery, court proceedings, and other factors beyond the organization's control may result in the whistleblower's identity becoming known.

7. THE PROCESS

The policy should explain the process: What will happen as a consequence of the report? This aspect of the written policy will have to be general because each report will require different responses. The recipient of the report should respond immediately, notifying the whistleblower that the report has been received and briefly describing the steps that will be taken in response to the report. When possible, the recipient also should tell the whistleblower when the recipient will next contact the whistleblower.

8. INVESTIGATIONS

Investigations stemming from reports should be discreet and made on a need-to-know basis. E-mail and other unsecure modes of communication should be avoided for discussions in connection with the investigation.

9. FOLLOW-UP

The policy should provide for follow-up with the whistleblower to make sure that the whistleblower truly believes that the issue raised has been satisfactorily dealt with. A whistleblower who perceives that his efforts have been ignored is a dangerous person from the organization's standpoint. This is a person who may decide to contact the media, a regulator, or a lawyer.

10. LOGGING AND AUDITS

Each report should be recorded in a secure log. Log entries should include the whistleblower's identity, the date and nature of the report, a description of the responses and the resolution, a statement that the whistleblower has been notified of the resolution, and an indication whether the whistleblower is satisfied with the outcome. A designated compliance officer should audit the logs and the policy periodically. Good candidate for this task include the organization's general counsel, a board member, or the organization's outside legal counsel.

11. RETALIATION

The policy should prohibit retaliation against whistleblowers and specify the consequences resulting from retaliatory actions.

12. AFFIRMATIVE DUTY

Some organizations impose an affirmative duty on employees to report activity that violates organizational ethics codes, other standards, or the law. In theory, this sort of affirmative duty makes sense. Unfortunately, childhood has taught many of us that tattletales and teacher's pets are to be shunned. As a consequence, imposing an affirmative duty to report may provide the organization with a false sense of security. If an organization decides to impose an affirmative duty on its employees, it should clearly spell out the consequences resulting from noncompliance.

13. BOARD REVIEW

The board should periodically receive a report on the nature and number of complaints. The board should consider organizational changes when there are repeated reports raising the same issue.

14. EMPLOYEE HANDBOOK

The policy should be included as part of the employee/volunteer handbook. It should state that it is subject to change at the discretion of management. The policy will need to be communicated to others through memo or contract terms.

B. Third-Party Hotlines

Some organizations rely on third-party whistleblower hotlines to assure their employees greater anonymity in filing whistleblower reports. The proliferation of these providers is a direct result of the Sarbanes-Oxley Act of 2002, which mandates that certain publicly-traded corporations provide employees with the opportunity to report certain concerns on an anonymous basis. Anecdotal evidence indicates that nonprofits probably have not widely adopted the use of these third-party hotlines, but some hospitals and universities probably have.

1. EVALUATING THIRD-PARTY HOTLINES

In evaluating any third-party hotline, the CAA should ask the following questions?

a) Is the hotline 24/7/365?
b) Is the hotline staffed by personnel or is it a web-based or e-mail system?
c) How do callers know that it is anonymous? How does a caller's number appear on the caller id system?
d) What is the background of those who answer telephone-based hotlines? Are they lawyers or paralegals? Do they receive special training?
e) Do the operators utilize scripts to conduct the interview or do they make it up as they go? What does the hotline do to assure consistency in how calls are handled?
f) How do the operators record the data? Do they type comments into a computer database? Are phone conversations recorded? If so, how is anonymity maintained?
g) Does the hotline provide callers with case numbers so that they can call back at a later time with additional information and concerns without the need to start from the beginning?
h) Does the hotline have multi-lingual capabilities?
i) Are calls taken in a call center or in a more private setting?
j) Does the system have time-stamp and other controls that prevent reports from being altered after the fact?
k) How does the hotline report calls to the organization? Are the reports encrypted if transmitted electronically?
l) Does the service offer materials and information sessions to the nonprofit's employees and other stakeholders so they are aware of the system?

Many of these questions also are relevant to a nonprofit that relies on in-house whistleblower reporting schemes.

2. THIRD PARTY SERVICE PROVIDERS

Here are the names and Web addresses for a number of third-parties who provide hot line services:

a) Allegiance at http://www.allegiance.com
b) Clearview at http://www.clearviewpartners.com/
c) Ethical Advocate at http://www.ethicaladvocate.com
d) Ethics Point at http://info.ethicspoint.com

e) Global Compliance at http://www.globalcompliance.com.
f) Lighthouse at http://www.lighthouse-services.com
g) Report Line at http://www.reportline.net
h) Silent Whistle at http://silentwhistle.allegiance.com

CAPLAW has not worked with any of these organizations. The inclusion of their names on this list is not an endorsement of their services. A CAA considering any of these organizations must conduct its own due diligence.

3. COST
A CAA should contact the providers to obtain cost estimates. For ballpark purposes, one provider claimed the cost could be as low as $1.50 per employee per year.

4. MULTIPLE FOCUSES
A CAA that decides to use a hotline service should consider the types of complaints that it wants directed to the hotline. Many of these services focus on financial fraud and abuse, but some services also handle employment practice and client protection (e.g. child or elder abuse by staff members) issues.

C. False Claims Act

The Federal False Claims Act provides for the imposition of penalties on entities that make false claims to the Federal government. Section 3730(h) of Title 31 of the United States Code provides protection to employees who blow the whistle. Specifically, Section 3730(h) provides:

> Any employee who is discharged, demoted, suspended, threatened, harassed, or in any other manner discriminated against in the terms and conditions of employment by his or her employer because of lawful acts done by the employee on behalf of his employer or others in furtherance of an action under this section, including investigation for, initiation of, testimony for, or assistance in an action filed or to be filed under this section, shall be entitled to all relief necessary to make the employee whole.

A number of organizations have adopted False Claims Act polices. These are typically hospital systems and other organizations that are dependent on government funding or reimbursement. These policies define what a false claim is, described the consequences from making a false claim, and include references to the organization's whistleblower policy.

D. Retaliation — Sarbanes-Oxley

In 2002, Congress enacted comprehensive corporate governance legislation directed at publicly-traded companies. This legislation carries the title "Sarbanes-Oxley Act of 2002." Among its many provisions are four that pertain to whistleblowers, but only one is relevant to CAAs because it applies to all employers rather than just publicly-traded companies. This provision criminalizes retaliation by CAAs and other employers for retaliation against whistleblowers who provides a law enforcement officer with any truthful information relating to the commission or possible commission of any Federal offense.

Specifically, Section 1513 of Title 18 of the United States Code provides:

> Whoever knowingly, with the intent to retaliate, takes any action harmful to any person, including interference with the lawful employment or livelihood of any person, for providing

to a law enforcement officer any truthful information relating to the commission or possible commission of any Federal offense, shall be fined under this title or imprisoned not more than 10 years, or both.

E. Retaliation – Federal Employment Law

Several of the better-known federal employment laws contain provisions providing protection to whistleblowers.

1. OSHA

To help ensure that employees are, in fact, free to participate in safety and health activities, Section 11(c) of OSHA prohibits any person from discharging or in any manner discriminating against any employee because the employee has exercised rights under OSHA. These rights include complaining to OSHA and seeking an OSHA inspection, participating in an OSHA inspection, and participating or testifying in any proceeding related to an OSHA inspection.

2. ADA

The Americans with Disabilities Act contains whistleblower provisions, which prohibit discrimination against any individual who makes a charge, testifies, assists, or participates in an investigation, proceeding, or hearing under the ADA. Moreover, it is unlawful to coerce, intimidate, threaten, or interfere with any individual who exercises rights granted under the ADA or assists someone to exercise their rights.

3. FLSA

Under Section 215 of Title 29 of the United States Code, it is a violation of the Fair Labor Standards Act to discharge or in any other manner discriminate against any employee because such employee files a complaint or institutes proceedings under the FLSA, or testifies in such a proceeding.

4. FMLA

Under Section 2615 of Title 29 of the United States Code, it is a violation of the Family and Medical Leave Act for any employer to interfere with, restrain, or deny the exercise of or the attempt to exercise, any right provided under the FMLA. Moreover, it is a violation of the FMLA for an employer to discriminate against any individual for opposing practices that are unlawful under the FMLA. The FMLA imposes liability on employers that retaliate against employees for exercising their rights under the FMLA.

F. The Federal Sentencing Guidelines

Mention the Federal Sentencing Guidelines and most people say, “What do they have to do with nonprofits and corporations?” Actually a lot, if the nonprofit engages in criminal activity. Such activity could result from an employee’s efforts to obstruct a federal investigation, cover-up fraudulent reimbursement activity, or any of the other type of crimes that corporations can be charged with. The guidelines instruct judges to take into account the presence of a whistleblower policy when punishing a corporation for the misdeeds of employees that are attributed to the corporation. Chapter 8 of the Federal Sentencing Guidelines (2004) provides as follows:

> The guidelines and policy statements in this chapter apply when the convicted defendant is an organization. Organizations can act only through agents and, under federal criminal law, generally are vicariously liable for offenses committed by their agents. At the same time, indi-

> vidual agents are responsible for their own criminal conduct. Federal prosecutions of organizations therefore frequently involve individual and organizational co-defendants. Convicted individual agents of organizations are sentenced in accordance with the guidelines and policy statements in the preceding chapters. This chapter is designed so that the sanctions imposed upon organizations and their agents, taken together, will provide just punishment, adequate deterrence, and incentives for organizations to maintain internal mechanisms for preventing, detecting, and reporting criminal conduct....These guidelines offer incentives to organizations to reduce and ultimately eliminate criminal conduct by providing a structural foundation from which an organization may self-police its own conduct through an effective compliance and ethics program. The prevention and detection of criminal conduct, as facilitated by an effective compliance and ethics program, will assist an organization in encouraging ethical conduct and in complying fully with all applicable laws.

Section 8B2.1(b)(5) then provides:

> The organization shall take reasonable steps—
>
> (A) to ensure that the organization's compliance and ethics program is followed, including monitoring and auditing to detect criminal conduct;
>
> (B) to evaluate periodically the effectiveness of the organization's compliance and ethics program; and
>
> (C) to have and publicize a system, which may include mechanisms that allow for anonymity or confidentiality, whereby the organization's employees and agents may report or seek guidance regarding potential or actual criminal conduct without fear of retaliation.

G. State Analogues

State laws also provide protection to whistleblowers. These protections are often analogous to the ones under federal law, or they can take the form of more general protections under state fair labor laws. The following are two examples of state laws:

1. ILLINOIS WHISTLEBLOWER ACT. Under Illinois 740 ILCS 174, an employer cannot make, adopt, or enforce any rule, regulation, or policy preventing an employee from disclosing information to a government or law enforcement agency if the employee has reasonable cause to believe that the information discloses a violation of a state or federal law, rule, or regulation. Nor may an employer retaliate against an employee for disclosing information to a government or law enforcement agency, where the employee has reasonable cause to believe that the information discloses a violation of a state or federal law, rule, or regulation. The act provides the employee with the right to bring a lawsuit for damages in the event of a prohibited retaliation.

2. CALIFORNIA LABOR CODE. Section 1102.5 of California's Labor Code provides that no employer may make, adopt, or enforce any rule, regulation, or policy preventing an employee from disclosing information to a government or law enforcement agency, where the employee has reasonable cause to believe that the information discloses a violation of state or federal statute, or a violation or noncompliance with a state or federal rule or regulation. Moreover, no employer may retaliate against an employee for disclosing information to a government or law enforcement agency, where the employee has reasonable cause to believe that the information

discloses a violation of state or federal statute, or a violation or noncompliance with a state or federal rule or regulation.

H. Resources

The following resources may prove useful to anyone who is looking for more detailed information.

1. Stephen M. Kohn, Michael D. Kohn, and David K. Colapinto, WHISTLEBLOWER LAW: A GUIDE TO LEGAL PROTECTIONS FOR CORPORATE EMPLOYEES (Praeger 2004).

2. Policies found on the Web should never be adopted by an organization without a thorough review and analysis of the policy in terms of the organization's own culture, needs, or operating environment. With that caveat, CAAs should google the phrase "whistleblower policy." This search will return a number of policy examples which will show how other organizations have dealt with the issue.

V. Background Information — Evaluating the Board Chair

The members of the board should not automatically reappoint the board chair to repeated terms unless the board chair is adequately discharging his duties. A board chair is a good one if the chair:

A. Starts and ends the meetings on schedule.

B. Adheres to an agenda.

C. Keeps the board informed of all major issues and seeks board member input.

D. Maintains decorum during board meetings.

E. Curbs extraneous comments and digressions during board meetings.

F. Avoids creating board factions or regularly siding with one existing faction.

G. Demonstrates respect for different points of view.

H. Maintains an even temperament.

I. Appears and is approachable.

J. Delegates tasks to appropriate committees and individuals on the board.

K. Fosters and maintains an excellent working relationship with the executive director and staff members who have regular contact with the board.

L. Stays on top of ongoing issues and problems, asking for regular or progress reports from the ap-

propriate individuals or committees.

M. Demonstrates follow through.

N. Anticipates potential problems before they become actual problems.

O. Seeks help from outside experts (e.g., lawyers, accountants, and consultants) when the board or the organization lack the expertise (as opposed to winging it).

P. Acknowledges when a mistake has been made.

Q. Refuses to tolerate efforts to circumvent rules or engage in illegal activity.

R. Keeps an eye on the long-term direction of the organization.

S. Provides a good public face for the organization.

T. Takes the board's oversight function seriously.

VI. Background Information — Financial Reporting, Internal Controls, and Auditing Standards

A. Resources

The following resources may prove useful to anyone who is looking for more detailed information.

1. American Institute of Certified Public Accountants, NOT-FOR-PROFIT AUDIT AND ACCOUNTING GUIDE (Updated Annually)

2. Gerald M. Zack, FRAUD AND ABUSE IN NONPROFIT ORGANIZATIONS: A GUIDE TO PREVENTION AND DETECTION (Wiley 2003).

3. Bruce Chase, NOT-FOR-PROFIT ACCOUNTING AND REPORTING: FROM START TO FINISH (AICPA 2006).

4. William E. Thompson, INTERNAL CONTROLS: DESIGN AND DOCUMENTATION (AICPA 2006).

5. Phil Sherman, ANALYTICAL PROCEDURES FOR NONPROFIT ORGANIZATIONS (AICPA 2005).

6. STATEMENTS ON AUDITING STANDARDS NO 99: CONSIDERATIONS OF FRAUD IN FINANCIAL STATEMENT AUDITS (AICPA 2002).

This auditing standard was promulgated in the aftermath of the Enron, WorldCom, Global Crossing, and other corporate scandals that came to light in 2001. It recognizes that the CPA's primary purpose in conducting a financial statement audit is not the detection of fraud, but

that the public nevertheless assumes that is exactly the purpose of an audit. Although directed at external audits, this relatively short guide is an important resource for nonprofit broads because its focus is more on thinking about on the big-picture aspects of fraud rather than specific and technical methods for detecting fraud.

Case 1: The Executive Director's Role Vis-a-Vis the Board

I. Facts — Situation 1

Red Community Action (Red CAA) was located in a major urban community. It was the recipient of an annual $10 million grant to fund its Head Start program.

A. Investigation

HHS appointed a 31-person task-force to conduct an investigation, resulting in 305 people being interviewed. According to one newspaper account, the report characterized the executive director as a virtual tyrant, who had instituted an autocratic decision process. He not only served as the executive director, but also as the agency's CFO and chairman of the agency's board of directors.

B. Financial Management

HHS, acting through the Administration for Children and Families, terminated Red CAA's Head Start contract. One report concluded that in just one year, $397,000 in Head Start funds were misappropriated. It also noted the Red CAA did not always rely on competitive bidding, and that when it did, the contract was not always awarded to the low bidder. The inquiry also uncovered poor grant administration and recordkeeping.

C. Hand Picked Board Members

According to a letter written to a local newspaper, the executive director carefully handpicked board members.

II. Facts — Situation 2

Five Rivers Community Development Corp was not a CAA, but nearly two-thirds of its funding came from local, state, and federal grant money.[1] Under its bylaws, Five Rivers was subject to a requirement that one-third of its board be comprised of individuals from the income group and geographic region served by Five Rivers.[2] The agency was charged with creating affordable housing and economic opportunities,[3] but its focus shifted to offering classes on buying homes and starting new businesses.[4] Between 1995 and 2007, it received somewhere around $5 million in federal, state, and local governmental funding.[5]

A. Little Apparent Board Oversight

In an August 20, 2006 story, reporter David Wren of the Sun News wrote that Five Rivers "operated with little apparent oversight while the executive director's salary nearly doubled in four years."[6]

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1 David Wren, *Nonprofit Pay Rises Under Little Oversight*, Sun News, Aug. 20, 2006.
2 *Id.* This requirement was apparently imposed by the bylaws.
3 David Wren, *Nonprofit's Board Requests an Audit*, Sun News, Sept. 23, 2007.
4 *Nonprofit Pay Rises Under Little Oversight*, note 1, *supra*.
5 David Wren, *Investigation of Five Rivers Winding Down*, Sun News, July 10. 2007.
6 *Nonprofit Pay Rises Under Little Oversight*, note 1, *supra*.

B. Three Employees

When Wren first broke the story, Five Rivers had three employees: Beulah White, its executive director, an unnamed receptionist, and White's daughter, Dayo Smith, who served as CFO. White helped found the agency.

C. The Board

White chose the board. According to Wren,

> White told The Sun News she has never had a job performance evaluation and board members, with the exception of Holmes, say they have never approved raises for her or discussed her salary and benefits.

The bylaws provided that the board was to have no fewer than seven members. When the scandal broke, the board was operating with only four directors.

D. Initial Claims

The board claimed that it reviewed general financial statements at bimonthly meetings and approved an annual budget. But one board member told Wren, "Since I've been on the board, we have not discussed her salary…It has never come up." Initially one board member claimed that "Nothing transpires without the permission of the board."

E. Revolving Boardroom Door

Since 1998, Five Rivers had 33 different board members. Many were handpicked by White.[7] One person told Wren,

> I saw a side of Mrs. White that concerned me….She wanted people on the board who she could easily manipulate. She wanted people who when she said, 'Jump,' they would say, 'How high?'

F. Board Member Attendance

Some former board members told Wren they rarely attended board meetings. According to Wren,

> State Rep. Vida Miller, D-Pawleys Island, said she attended one meeting during her four-year tenure on the Five Rivers board.
>
> "I just didn't have the time to participate," said Miller, who was on the board from 1997 to 2000.

G. Vote of Confidence Meeting May Have Violated Open Meeting Laws

At a late August 2006 closed-door session, the board gave its full support to the Five Rivers' staff.[8] According to Wren, the meeting may have been held in violation of the South Carolina Freedom of Information Act.

H. Board Requests Audit

A little over a month after Wren's first article appeared, the Five Rivers board requested an audit.[9] This came two days after a state senator requested a criminal inquest into Five Rivers' affairs.

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7 David Wren, *Conflicts of Interest at Five Rivers*, Sun News, Sept, 20, 2006.

8 David Wren, *Agency's Staff Receives Board Support*, Sun News, Aug. 30, 2006.

9 *Nonprofit's Board Requests an Audit*, note 3, *supra*.

I. Board Resignations

By October 19, 2006, three of the four members had resigned.[10] Wren recounted his conversation with board president Sam Livingston,

> Livingston said White and Smith will not follow the board's direction and have been running Five Rivers as if it were their personal business.
>
> "They don't want to adhere to the wishes of the board, so they don't need a board," Livingston said. "They are running the agency the way they want to run it, and they want to continue running it their way. The board is not going to be a part of that foolishness."

White and Smith refused to explain to the board how they spent $617,000 of a $994,100 grant. The board also found out that White was selling agency land without board approval. The board did not know for three years that one of White's other children was on the payroll.[11]

J. Conflicts of Interest

Wren detailed the many conflicts of interest in a September 30, 2006 article.[12] In one case, White asked a real estate developer to join the board, but that was delayed until after the developer sold Five Rivers three acres of land. In another case, a $25,000 loan was made to a board member shortly after her term expired. In still another case, Five Rivers purchased 2.07 acres of land from the cousin of an apparent board member. At one point, White's son was a member of the board. Several board members received free technical assistance through Five Rivers. One board member was a vice-president at a bank that had made a mortgage loan to Five Rivers, although he was not a board member at the time of the loan's origination. One elected official earmarked a $145,000 grant for a Five Rivers project.[13] His nephew's architectural firm received $69,653 for initial design work pursuant to a no-bid contract. According to one person quoted by Wren, Five Rivers had a conflicts-of-interest policy.

K. Compensation

1. BASE COMPENSATION

White was paid $413,134 in salary and bonuses between 2001 and July 2006.[14] White's pay increased 91% between 2000 and 2004.[15] Smith received $255,625 in salaries and bonuses since 2001. Two board members indicated that they did not know the executive director's salary.

2. BENEFITS

There were also $81,638 in indirect benefits provided to White, which included "travel and personal use of the agency's Volvo."[16]

3. UNKNOWN EXPENDITURES

Wren reported that,

10 David Wren, *3 Five Rivers Board Members Leave Posts*, Sun News, Oct. 19, 2006.
11 David Wren, *Board Not Consulted on Wages*, Sun News, Dec. 10, 2006
12 *Conflicts of Interest at Five Rivers*, note 15, *supra*.
13 David Wren, *Agency Given $1.5 Million in Federal Funds*, Sun News, Aug. 20, 2004.
14 David Wren, *Board Not Consulted on Wages*, Sun News, Dec. 10, 2006.
15 *Nonprofit Pay Rises Under Little Oversight*, note 1, *supra*.
16 *Board Not Consulted on Wages*, note 27, *supra*.

A review of Five Rivers' travel records shows White and Smith regularly write checks from the agency's bank account to each other, with no apparent independent oversight.

4. IN THE AGGREGATE

According to Wren,

Nearly half of the agency's expenses since 1996—more than $1.5 million—have been for salaries, fringe benefits, travel, health and automobile insurance for staff members and other costs that benefit White, Smith and other Five Rivers employees.[17]

In summarizing his findings in a second article, Wren wrote,

The Sun News' reports showed that most of the $5 million in state and federal grants Five Rivers received between 1995 and 2006 went to pay salaries, health and life insurance, travel, meals and other expenses that benefited White and her children.[18]

L. Consequences

1. AGENCY CLOSED

The agency closed its doors on November 10, 2006. On September 11, 2007 Wren reported that its executive director and the CFO were charged with "15 felony counts of embezzlement, criminal conspiracy, and breach of trust with fraudulent intent." These were state law charges. A federal criminal investigation is ongoing.

2. TAX LIEN

The South Carolina Department of Revenue filed a tax lien for unpaid amounts withheld from employees.[19]

3. MISSION FAILURE AND FORECLOSURE

A proposed community center was never built and a 3.03 acre site owned by Five Rivers was sold in a foreclosure sale.[20]

4. DEMAND FOR REFUND

The U.S. Department of Housing and Urban Development has demanded that Five Rivers repay $418,180 in grant money[21] HUD has alleged that the money was to be used for construction, but was misspent.[22]

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17 *Nonprofit Pay Rises Under Little Oversight*, *Sun News*, note 8, *supra*.
18 David Wren, *15 Felony Counts Filed*, Sun News, Sept. 11, 2007.
19 David Wren, *Tax Lien Placed on Five Rivers*, Sun News, Mar. 22, 2007.
20 David Wren, *Five Rivers Losing Land*, Sun News, Feb. 2, 2007.
21 *Five Rivers Must Repay HUD Funds*, Sun News, Dec. 8, 2006.
22 *Five Rivers Losing Land,* note 38, *supra.*

III. Questions for Discussion

The following questions are offered for discussion:

A. What exactly are the roles of the board of directors and the executive director?

B. Does the board have authority to remove an autocratic executive director?

C. What should the board do if it votes to remove the executive director, but the executive director won't accept the decision?

D. How should tasks and responsibilities be divided between the board and the executive director?

E. Should the CFO report directly to the board, or to the executive director?

F. Subject to and taking into account specific rules govering CAAs, who should nominate and select members to the boardof directors?

G. What should the board do if the executive director is not forthcoming with information?

H. Should people who have benefited from an agency's services be permitted to serve on its board? If so, should there be a mandatory gap between the time services were received and the time of board service?

I. Should an organization's conflicts-of-interest policy continue to apply to a former director for some specified period of time?

J. What was Beulah White's biggest mistake?

IV. One Suggested Solution

A. Overview

The executive director and her staff are charged with the day-to-day operation and management of the organization. The board of directors is charged with oversight. It sets policy, assesses the adequacy of financial resources, approves the budget, reviews conflicts of interest, hires and evaluates the executive director, sets the executive director's compensation, reviews the organization's overall compliance with laws, and performs other oversight functions.

The relationship between the board and the executive director should be a working partnership, but there must be independence if there is to be effective oversight. Given that fact, prospective board members should be identified through a process independent of the executive director and the executive director should not control the election process. CAAs are subject to a prescribed election process, but that does not necessarily prevent the board from identifying potential candidates and encouraging them to seek board positions.

Setting aside CAAs,many other nonprofit boards wonder whether the executive director should be a member of the board. Unless there is a specific reason for overlap, the executive director should not be a member of the board. That creates an unhealthy shift in the balance of power toward the executive director. Overlap is particularly problematic if the executive director serves as the board's chair. Then the executive director is in a position to make her agenda the board's. Overlap is prohibited in the case of organizations subject to the Head Start Act.

Sometimes boards justify including the executive director on the board to serve as the tie-breaker. This is a hollow rationale, with no practical import. In many cases, boards reach unanimous decisions by building consensus. When a board is sharply divided, the factions often agree to revisit the issues after attempting to come at it from a different perspective. When the board proceeds with a vote, the executive director may actually find the best course is to abstain so as to not permanently alienate a board faction.

The board offers the executive director the opportunity to test ideas before she implements them. No one has infallible judgment. By relying on a board comprised of knowledgeable people, the executive director may be able to identify potential problems in her thinking, permitting her to avoid decisions that could prove costly both to her and the nonprofit.

B. Conflicts of Interest

The board should put in place a meaningful conflicts-of-interest policy. Five Rivers had a conflicts policy, but not one that people apparently paid much attention to. Like Five Rivers, CAAs are faced with a legal requirement that can result in service recipients being elected as directors. It would be inappropriate to exclude members of the community who participate in CAA programs from board service. Under no circumstance, however, should board members be given any preference in terms of program or service eligibility that is linked to their service as board members.

C. CFO Access to the Board

The board should give consideration to whether and how it should provide the CFO access to the board in the event that there are material financial issues that the CFO believes are being kept from the board. The need for such access should be extremely rare because the CFO either should be making regular presentations during board meetings or working closely with the board's finance or audit committees. Unfortunately, there have been incidents where executive directors of nonprofits have engaged in cover-ups to hide serious problems from the board. In these instances, the board wants to make sure that the CFO feels comfortable going directly to the board. One approach is to ask the CFO to contact the head of the audit or finance committee when the circumstances threaten the agency and other alternatives at resolution have not worked.

D. CFO Should Not Be the Executive Director

The CFO is charged with measuring the financial performance of the organization. In that capacity, the CFO is effectively reporting on matters that should affect the board's evaluation of the executive director. For these reasons, the executive director should not serve as CFO. The board shouldn't want the executive director to be the one who prepares the financial reports that offer one perspective on the executive director's ability to manage.

E. Dealing with the Troublesome Executive Director

The board is vested with the legal power to terminate the executive director. Obviously, termination is a serious step and should be taken only when there are no other viable options. Both Red CAA and Five Rivers offer examples of those rare instances where the board should have taken decisive action. By all accounts, the board members did not suffer adverse consequences when Five Rivers closed or Red CAA's grant funds were transferred to another agency, but the service recipients did suffer. Programs were disrupted, scare resources were wasted, and promises were broken.

F. White's Mistake

Five River's former executive director, Beulah White, has been charged with a number of felonies. Time will tell whether she is convicted, and until she is, she is presumed to be innocent. Without suggesting that people engage in deceit, White's big mistake, if the allegations turn out to be true, was not consulting the board. The newspaper story describing the criminal charges suggests that the charges don't stem from what most characterize as White's excessive salary, but from her failure to adequately document and obtain board approval for certain expenses and payments to herself. Given the apparent passive nature of the Five Rivers board, White probably could have made the prosecutor's job much more difficult by providing the board with lots of paper resolutions for approval. Again, this is not intended as a recommended course of action, but it does demonstrate the board's power and authority, as well as the consequences of not exercising that power.

V. Background Material

For additional commentary, review Sections I (Setting Compensation) and IV (Whistleblowers) of the Background Material accompanying the case studies.

Case 10: The Board's Response to a Whistleblower

I. Context

Although everyone applauds whistleblowers when they bring fraud and abuse to light, whistleblowers can be a mixed blessing. The board and management are charged with protecting the organization's assets and integrity. They should welcome efforts by employees and others to surface wrongdoing, particularly when a supervisor is attempting to cover up inappropriate activities. But not every whistleblower is correct in his characterization of events or activities. Sometimes supervisors will legitimately attempt to diffuse the whistleblower's efforts. Unfortunately, what may be a natural human response on the part of the supervisor may be viewed as retaliatory action by the whistleblower. This can lead to employment practices litigation.

As a consequence, boards and managements must walk a fine line. On the one hand, the board should adopt policies that encourage whistleblowers to bring potential problems to the board's and management's attention. On the other hand, the board must make sure that whistleblowers don't disrupt the organization by aggressively pursuing what are erroneous claims and concerns. One observer has said, "Whenever there is a whistleblower, somebody is going to be fired. That person will either be the wrongdoer, or the person who makes the accusations that turn out to be false." That may be a common perception, but the board must assure that there is no retaliation against whistleblowers who are acting in good faith.

A. False Claims Act

The Federal False Claims Act provides for the imposition of penalties on entities that make false claims to the Federal government. Section 3730(h) of Title 31 of the United States Code provides protection to employees who blow the whistle. Specifically, Section 3730(h) provides:

> Any employee who is discharged, demoted, suspended, threatened, harassed, or in any other manner discriminated against in the terms and conditions of employment by his or her employer because of lawful acts done by the employee on behalf of his employer or others in furtherance of an action under this section, including investigation for, initiation of, testimony for, or assistance in an action filed or to be filed under this section, shall be entitled to all relief necessary to make the employee whole.

B. State Analogues

State laws also provide protection to whistleblowers. These protections are often analogous to the ones under federal law, or they can take the form of more general protections under state fair labor laws. The following are two examples of state laws:

1. Illinois Whistleblower Act

Under Illinois law 740 (ILCS 174), an employer cannot make, adopt, or enforce any rule, regulation, or policy preventing an employee from disclosing information to a government or law enforcement agency if the employee has reasonable cause to believe that the information discloses a violation of a state or federal law, rule, or regulation. Nor may an employer retaliate against an employee for disclosing information to a government or law enforcement agency, where the employee has reasonable cause to believe that the information discloses a violation of

a state or federal law, rule, or regulation. The act provides the employee with the right to bring a lawsuit for damages in the event of a prohibited retaliation.

2. California Labor Code

Section 1102.5 of California's Labor Code provides that no employer may make, adopt, or enforce any rule, regulation, or policy preventing an employee from disclosing information to a government or law enforcement agency, where the employee has reasonable cause to believe that the information discloses a violation of state or federal statute, or a violation or noncompliance with a state or federal rule or regulation. Moreover, no employer may retaliate against an employee for disclosing information to a government or law enforcement agency, where the employee has reasonable cause to believe that the information discloses a violation of state or federal statute, or a violation or noncompliance with a state or federal rule or regulation.

II. Facts

Alpha Community Action (Alpha CAA) had a subsidiary that developed and managed affordable housing. An employee complained to another employee and a member of the subsidiary's board that the subsidiary's practices involved "collusion, conflicts of interest and fraud' in the "preparation of office reports, methods of awarding housing units, the tenancy selection process, the bidding process, accounting methods and procedures, [and] awarding contracts." The employee, who had a $30,000 annual salary, was terminated. She filed suit claiming harassment, intimidation, and wrongful termination. The suit focused on the actions of the housing and community services director and the deputy executive director. Newspaper accounts are unclear whether these individuals worked for Alpha CAA or its subsidiary. The outcome of the suit is unknown.[1]

III. Discussion Questions

The following questions are offered for discussion:

A. Is it sufficient for a board to adopt a whistleblower policy, or are there other steps that a board should take to protect whistleblowers?

B. Is a whistleblower policy primarily for the benefit of employees?

C. Should the board have one point person to handle all whistleblower complaints?

1 This incident is now over a decade old. That places practical limitations on obtaining additional details.

IV. One Suggested Solution

Every nonprofit should adopt a whistleblower policy, even those operating in jurisdictions that provide whistleblowers with no or minimal protections. Although many view whistleblower policies as laudable employment practices, the organization and its board are the primary beneficiaries of these policies. They are another internal control. Those who are willing to report a problem to the board or individuals outside normal reporting channels are bringing important information to the board's attention, information that some might prefer remain hidden.

A. Written Policy

A written statement is only the first step in implementing a whistleblower policy. The board must foster an environment that encourages employees to report potential problems. The board can facilitate the process by incorporating the policy into the employee handbook and other employment practice guidelines. The board should also instruct management to address the policy as part of ethics and employment law training.

B. Building Channels

The board should encourage management to develop communication channels. In the case of employment practices, the board might designate someone in the personnel department as the proper person to receive reports from employees. In the case of concerns involving financial fraud and abuse, the board might designate its own audit or finance committee as the appropriate recipient for reports.

C. Anonymity

The board must address the question of anonymity and confidentiality. This means working with legal counsel. A blanket promise of anonymity can hamper an investigation into allegations. If the report results in formal legal proceedings, the employer may not be able to keep the identity of whistleblower confidential. However, it is a good idea to permit anonymous reporting because despite assurances that they will be protected, many people nevertheless continue to fear and expect retaliation. Ultimately, the primary purpose of the policy is to protect the organization from the consequences flowing from misdeeds, legal violations, and abusive or inappropriate behavior. That means that the organization should take the necessary steps to surface what it vital information. If management perceives that the vast majority of employees fear retaliation, the organization should assess why that may be so and identify appropriate changes in the organization's operations. In the meantime, the organization should consider one of the many hotline operators providing these services to employees.

D. Consult an Employment Practices Lawyer

Reports by whistleblowers often turn into "he said, she said" disputes, making these reports potentially explosive. When dealing with a whistleblower, the organization should err on the side of seeking legal counsel from an employment lawyer. As an example, an organization might in good faith decide to reassign a whistleblower to protect her, but the whistleblower could mistakenly characterize the new assignment as retaliation, or could claim that the new assignment violates the Americans with Disabilities Act or other acts prohibiting different forms of discrimination.

V. Background Material

For additional commentary, review Section IV (Whistleblowers) of the Background Material accompanying the case studies.

Case 11: Developing and Maintaining Communication Channels

I. Facts

Case 2 considered the potential problems posed by the powerful board chairman. In that case, the chairman was Archie Brooks and the agency was the Central Iowa Employment and Training Consortium (CIETC). Take a few minutes to review that case if you don't recall the core facts.

A. Whistleblowers

CIETC's board might have been able to rectify CIETC's problems had it heard from the whistleblowers who attempted to alert various officials, including regulators and elected officials. Virtually all those who received alerts were slow to respond.

B. Initial Reports

In April 2006, an anonymous former CIETC employee talked with the media about what she had seen while working in CIETC's payroll department. [1] Recall that the scandal centered on excessive compensation, so this employee had a bird's-eye view. She requested anonymity out of fear over retaliation.

The former employee told KCCI 8 News that the misuse of public funds had been going on for years. She noticed several checks for $3,000 made out to top executives, causing her to copy them and report the matter to the FBI.

C. Investigatory Report

One of the more prominent whistleblowers was Kelly Taylor, a budget analyst with Iowa Workforce Development (IWD), a state agency that disbursed grant money to CIETC.[2] There are allegations that Jane Barto, IWD's deputy director, and Ramona Cunningham, CIETC's CEO, had a close personal relationship.[3]

During the course of an investigatory interview by state investigators,[4] Taylor identified the following five concerns: (1) the salaries and bonuses for CIETC executives; (2) the changes by an IWD employee to the way the budget analysts address issues in monitoring reports; (3) hiring procedures at IWD; (4) the treatment of Taylor by IWD management; and (5) employees on CIETC's payroll who performed work for IWD, not CIETC.[5]

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1 *Former CIETC Works Says Payroll Abuses Happened for Years: Worker Says Those at Top Knew of Misspent Funds*, KCCI 8 News, Apr. 8, 2004.

2 WHOtv.com, *Brooks Reacts to CIETC Memo*, May 22, 2006; *CIETC Scandal: The Week in Review*, Des Moines Register, Apr. 7, 2006; and Jonathan Roos, Jason Clayworth, and Clark Kauffman, *Audit Fallout Builds Pressure on Workforce Officials*, Des Moines Register, Apr. 5, 2006.

3 *CIETC Scandal: The Week in Review*, Des Moines Register, Apr. 7, 2006; and Clark Kauffman and Jonathan Roos, *Top Officials Quit Over State Job-Training Pay Controversy*, Des Moines Register, Apr. 6, 2006.

4 Summaries of a number of interviews by state investigators are available the *Des Moines Register's* Web site. Regrettably the summaries do not indicate who conducted the interviews. The *Register* identifies the summaries as government investigatory documents, but is less than clear in identifying the specific government unit that conducted the investigation.

5 Investigation Report Summary—Iowa Workforce Development—Summary of Interview with Kelly Thomas (Apr.

The State of Iowa conducted an extensive investigation into the scandal. Summaries of the interviews paint a detailed, but confusing picture of the contacts between the various participants.[6] Some of the interviews suggest or allege that there were attempts to thwart efforts to surface alleged wrongdoing. The Des Moines Register, in detailing the scandal, reported,

> "Jane Barto called our office in the region and requested that (Workforce Development) be allowed to investigate the matter," said Mason Bishop, the U.S. Department of Labor's deputy assistant secretary for employment and training. "And she assured our staff there was no indication of criminal behavior."
>
> Barto denied any attempt to discourage an investigation into CIETC.
>
> But the alleged call to federal officials indicates that Barto was attempting to overrule her agency's financial experts as they called for a federal investigation.[7]

The Register then details contacts by Kelly Taylor, the whistleblower working as an IWD budget analyst, with the Chicago office of the Department of Labor, reports by Taylor to his superior, allegations that Barto removed Taylor from the investigation, and allegations that IWD officials then tried to head off a federal investigation.

One whistleblower sent letters detailing CIETC's problems to Iowa's governor, a U.S. Senator and a member of the U.S. House of Representatives.[8] The whistleblower also indicated she mailed letters to several CIETC board members. There is some indication in the Register's reporting that the anonymous nature of the letters may have resulted in the letters receiving less attention than they might otherwise have received. According to the Register, the whistleblower who sent the anonymous letters was placed on administrative leave about two months after sending the letters.

II. Discussion Questions

The following questions are offered for discussion:

A. Although there is some indication that at least one whistleblower sent letters to certain members of CIETC's board, the whistleblowers appear to have focused their efforts on contacting people outside of CIETC. Why might that be the case?

B. If you were a high level official in an organization, would you be more inclined to respond to an anonymous letter than one from an identified individual?

C. What steps might CIETC's board have taken to encourage whistleblowers to report alleged wrongdoing to CIETC's board rather than to outsiders?

7, 2006).

6 See note 5, *supra*.

7 Clark Kauffman and Jonathan Roos, *Top Officials Quit Over State Job-Training Pay Controversy*, Des Moines Register, Apr. 6, 2006.

8 Jason Clayworth, *Ex-Worker Tells of '04 CIETC Alert*, Des Moines Register, Apr. 20, 2006.

D. What can a board do to prevent an executive director from hiding problems or wrongdoing from the board?

III. One Suggested Solution

A. The Dilemma

The board must rely on people within the organization to provide it with information about problems facing the CAA, but if senior management is the cause of those problems, lower-level employees will be reluctant to bring the problems to the attention of supervisors. To assure that the board receives vital information, the board must develop clear lines of communication with all employees so that employees know where to report their concerns. It also must make sure employees are comfortable in doing so.

B. Reasons for Silence

Lower level employees may decide to remain silent for a variety of reasons. First, and foremost, many fear retaliation. Second, an employee may not make a report because he is unsure whom to contact. Third, employees may have detected that the board is dysfunctional, leading to the conclusion that there will no response so why take the risk? Fourth, employees who are particularly disturbed by the circumstances may decide that the most expedient action is to seek employment elsewhere.

C. The Approach Taken by CIETC's Whistleblowers was Telling

CIETC's whistleblowers decided to report their concerns, but mostly to those outside of CIETC. This strongly suggests that CIETC's board was ineffective and nonresponsive. Brooks' comments to the media support that view. It also appears from the media accounts and interviews that the whistleblowers believed CIETC's senior management would not respond. That should come as no surprise given the fact that senior managers were the recipients of the compensation that caused the concerns.

D. Anonymity

Open-minded managers and boards are more likely to respond to complaints by persons who are willing to identify themselves. This is only natural. A number of CIETC's whistleblowers reported anonymously to outsiders. Not surprisingly, those outsiders were less responsive than they might otherwise have been had the whistleblowers identified themselves. People want the context that comes with knowing who is raising the complaint before taking action.

Although anonymity is less preferable from the board's standpoint, it may be necessary if the board wants information. Even when anonymity is assured, some employees may be highly suspicious of those assurances. Whatever the assurances, the CAA should be careful to point out that it cannot guarantee anonymity if formal legal proceedings result from the complaint. Although the CAA may intend to keep someone's identity confidential and certainly should do so if it has made assurances, the CAA may be required by law enforcement officials, judicial proceedings, or even funders, to make disclosures.

E. Organizational Culture

Obviously adopting and then publicizing a whistleblower policy is a step toward establishing an open-door policy. In truth, however, a piece of paper is not going to result in reports if the employees perceive senior management as Gestapo-like in their tactics. Long before the board adopts a formal whistleblower policy, it has established a de facto one as result of who it hires and

the control it exerts over employment practices and policies. If the board has shown that it is responsive to employees, it is much more likely to receive vital information from employees who are concerned about the organization, particularly if there are clear channels for communicating the information. The board shows that concern not in just how it responds to a whistleblower, but how it responds to employee questions and proposals in general.

F. Multiple Channels

CAAs should consider instituting multiple reporting channels for whistleblowers. For example, concerns over financial fraud and mismanagement might be directed to the board's audit committee, while concerns over employment practices might be directed to someone in the HR department or the board's compensation or personnel committee. Each CAA will have to consider its unique circumstances to determine what channels will work best for it.

G. Third Party Reporting Hotlines

A number of private companies have recognized the need for independent third party reporting. Some do offer services directed at nonprofits, but most focus on larger companies that have need for independent reporting because of the federal Sarbanes-Oxley Act (Section 301 requires anonymous reporting procedures, but this requirement only applies to publicly-traded companies subject to the Act) and concerns over the Federal Sentencing Guidelines.[9]

H. Solving Problems Before They Become Expensive

Whistleblowers who become frustrated may decide to raise their concerns outside of the organization, as was true in the case of one CIETC whistleblower. This can prove embarrassing if the whistleblower seeks the media's help, or expensive if the whistleblower contacts a lawyer. Section 3729 of Title 31 to the United States Code imposes liability on persons and organizations who knowingly present to the United States false or fraudulent claims for payment or approval. Section 3730 then goes onto provide for a private right of action by qui tams (private individuals that include a nonprofit's employees), which permits these individuals to participate in the recovery received by the government. A nonprofit may assume its employees are unlikely to file a suit. That may be true, but a Google search of "Federal False Claims Act" or qui tam returns results that point to a very active plaintiff's bar. Many states have adopted analogues to the Federal False Claims Act. A CAA that provides its employees with a clear avenue to bring wrongdoing to the attention of the board may be able to avoid expensive outside involvement by an aggressive lawyer.

IV. Background Material

For additional commentary, review Section IV (Whistleblowers).

9 Chapter 8 of the Federal Sentencing Guidelines (2004)

Case 2: The Powerful Board Chairman

I. Facts

The Central Iowa Employment & Training Consortium (CIETC) was created under Iowa law and is considered to be a governmental entity.[1] Despite that fact, CIETC functioned like a private nonprofit social service agency. CIETC was configured as a membership organization, with its members comprised of one city and several counties. Its members appointed CIETC's board of directors. CIETC offered education, employment, and training programs sponsored under state and federal grants and contracts. As of December 15, 2005, CIETC had 72 employees.

A. The Scandal

In 2006, news of a major scandal at CIETC began to emerge through Iowa's media outlets. The question was whether certain CIETC executive had received excessive compensation. One schedule shows that CIETC's CEO's compensation totaled $368,236 for CIETC's fiscal year ended June 30, 2005, with the chief operating officer's compensation being not far behind at $360,010 for the same period. Iowa's state auditor concluded,

> These procedures identified unallowable uses of federal funds, including excessive compensation packages to CIETC executive employees, improper allocation of salaries and supplemental payments to federal grants and indications of "less than arm's length" transactions between IWD and CIETC.

The circumstances eventually led to the federal indictment of several CIETC employees and of Joseph Archibald Brooks, Jr, the chairman of CIETC's board,[2] who pled guilty to federal fraud charges.[3] The indicted employees included CIETC's chief executive officer, chief operating officer, and chief accountant. One of the indicted employees pled guilty and agreed to testify against the others.[4] The trial has been postponed to February 2008.[5] CIETC is now largely defunct.[6]

B. Brooks as Board Chair

According to City View, Central Iowa's independent weekly, Brooks headed CIETC's board[7] from 1979 through 1996, when he was defeated in an election for city council. Brooks returned as CIETC's board chair in 1999, when he was re-elected to the city council. Brooks told City View that much changed from 1995 to 1999. Historically, CIETC's CEO performed oversight

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1 Office of the Auditor of the State of Iowa, Special Investigation of the Central Iowa Employment and Training Consortium and Iowa Workforce Development, Mar. 26, 2006.
2 U.S. Department of Justice, Former CIETC Executives Charged with Fraud: Former IWD Deputy Director and Former City Council Member Also Indicted, Jan. 16, 2007.
3 Abby Simons, *Brooks Pleads Guilty*, DES MOINES REGISTER, Oct. 20, 2007.
4 Jeff Eckhoff, *Ex-CIETC Executive Cleaning Rooms in Louisiana*, Des Moines Register, Sept. 15, 2007; and Archie Brooks, Four Others Indicted in CIETC Scandal, KCCI 8, Des Moines, Jan. 10, 2007.
5 Jeff Eckhoff, *CIETC Five to Stand Trial Feb 4*, Des Moines Register, Sept. 14, 2007.
6 Clark Kauffman, *Register Drops Secrecy Lawsuit Against CIETC*, DES MOINES REGISTER, Oct. 27, 2007.
7 This service includes being board chair of Central Iowa Regional Association of Government, CIETC's predecessor, according to an article. *In His Own Words: Archie Brooks on CIETC, the Affair, the Excuse and Those Odd Signatures*, City View, Apr. 13-19.

and payroll duties, reporting to the board as a whole. Brooks claims that in his absence, the board chair had become "a one-man oversight committee."

C. Compensation Decisions

Despite finding himself in a difficult position, Brooks has been willing to speak to the media, providing a glimpse of the internal workings of CIETC's board. Brooks began by telling KCCI 8 that,

> I did not do due diligence in the voluntary position I was in. I should have. I've admitted that. I'm ashamed, but it happened. You have trust in staff.[8]

He went onto to describe the decision process,

> My biggest frustration was during these monthly meetings. They had half-hour lunches, and then the meeting would last only 10 or 15 minutes. There was lack of participation or involvement by any of the board—more complacency than anything.

Brooks claimed that he approached the board about his role, but that the board was not concerned.[9] He told City View,

> They knew I was concerned, but there had never been any problems before.

He went on, as recounted in the City View article, to say,

> Beyond that, they wanted their 30-minute lunch and their 15-minute meeting…They were guilty of being too trusting and not paying attention to bad policy, just like me.

The report from Iowa's state auditor is consistent with Brooks' characterization of the board as uninvolved. In describing the process for authorizing certain employment agreements, the state auditor wrote,

> The agreements were authorized by the Chairperson of the CIETC Board of Directors.[10]

Later in the report, the state auditor continued,

> We interviewed 4 CIETC Board members, including 2 who serve on the Executive Committee. When asked if they received a packet containing the employment agreements, one recalled receiving the personnel policies, but all stated they did not receive the employment agreements. However, the Board members we spoke with confirmed the Chair stated at the November 2005 Board meeting that all future employment agreements would be reviewed by the Executive Committee.
>
> In addition, all Board members we spoke with stated they had not previously been informed of the base salary levels for any of the CIETC staff members. According to the Board mem-

8 *Brooks Described Hazy Oversight: Former Board Chairman Says He Made Mistakes*, KCCI 8, Des Moines, Iowa, Apr. 12, 2006

9 *In His Own Words: Archie Brooks on CIETC, the Affair, the Excuse and Those Odd Signatures,* note 5, *supra.*

10 Office of the Auditor of the State of Iowa, note 1, *supra*.

bers, detailed information related to the administrative operations of CIETC was not shared with the Board. The Board members also stated agenda items were not typically discussed by the Board. Instead, they were presented as if a decision had already been formulated by the CEO and/or Board Chairperson and the Board was being informed of the matter.

A significant portion of executive officer compensation appears to have been in the form of supplemental payments. The state auditor's report strongly suggests that these payments were largely at the discretion of CIETC's board chair.

D. The Independent Audits

Iowa's legislature conducted hearings in the wake of the scandal. At one of those hearings, legislators questioned an auditor who had performed routine audits of CIETC's books. In commenting on the failure of the audit to surface and correct the problem, one legislator said,

> I don't see the point in auditing when this was going on and you guys didn't catch them. I don't understand.[11]

The auditor responded that the audit was a general audit, not specifically designed to focus on the process by which compensation was determined or whether it was excessive. Tellingly, the auditor responded to the question,

> Well, we noted that they were receiving large compensation. We asked about it. We were provided with information that it had been approved, authorized by board, specifically signed off by their chairman of their board, who was an independent, appointed, elected government official with the specific responsibility of approving those levels….We talked with him. He said it had been approved.

II. Discussion Questions

There is one question that is ever present in assessing Brooks' behavior: Assuming the compensation to the executive officers was grossly excessive and that Brooks was in fact the one who authorized it, what was in it for Brooks, who has pled guilty "to conspiracy to funnel more than $1.8 million in federal job-training money to the agency's executives and admitted that he personally misappropriated $5,000. Seventeen other counts were dropped."[12] Several newspaper articles refer to conflicts of interest[13] and a possible personal relationship,[14] but as described and even if true, these connections are arguably too tenuous to explain why Brooks did what he did.

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11 *CIETC Auditor Testifies: Lawmakers Criticize Kincheloe for Not Asking More Questions*, KCCI 8, Des Moines, July 19, 2007.

12 *Brooks Pleads Guilty*, note 3, *supra.*

13 *Relatives Working for CIETC Raises Question: Nepotism Code is Outlined in State Law*, KCCI 8, Des Moines, Apr. 12, 2006. This report indicates that Brook's brother and step-daughter worked for CIETC.

14 One media outlet reported that in 1986 Brooks was accused of having a romantic relationship with Ramona Cunningham, CIETC's chief executive officer at the time of current scandal. *CIETC Scandal: This Week in Review*, Des Moines Register, Apr 7, 2006. A subsequent investigation determined that the allegations were false, but speculation emerged when the pay scandal surfaced in 2006. When asked whether he had an affair with Cunningham, Brooks told City View that they had dated twice (apparently meaning they had gone out on two dates). *In His Own Words: Archie Brooks on CIETC, the Affair, the Excuse and Those Odd Signatures,* note 5, *supra.*

With those prefatory remarks in mind, the following questions are offered for discussion:

A. Should the same person serve as board chair for decades?

B. Should the board ever delegate broad authority to the board chair for setting compensation levels?

C. What factors should members use to evaluate the performance of the board chair.

D. Should meals be served at board meetings? Does it matter whether the organization pays for the meal? Would meals be appropriate if each director brought his own food?

E. Are periodic bonuses or supplemental payments during the course of the year appropriate?

III. One Suggested Solution

A. Domineering Board Chairs

Other members of the board should be very leery of a domineering board chair. It is not clear whether Brooks was a domineering chair or simply filling the void created by a passive board. Many of the comments made by Brooks to the media strongly suggest he viewed himself as filling a void. Either way, the result is likely to be the same. There is a reason many nonprofit corporation statutes require a minimum of three directors and that there be a quorum of directors before decisions can be made. These laws favor collective decisions. As the problems at CIETC aptly demonstrate, unchecked authority and decisionmaking can lead to disaster.

B. Term Limits

Opinions will vary as to whether the same person should serve as the board chair for multiple terms. There are those who argue that the board and the executive director will eventually develop too cozy of a relationship, which will marginalize the rest of the board. That is clearly a concern given human nature. But if the board chair is doing a good job and retaining his objectivity, does it make sense for the bylaws or other rules to prevent the chair from continuing to serve in that capacity? Not surprisingly, there is no clear consensus when it comes to term limits. Whatever the board's decision is on term limits, its members must be vigilant in monitoring the board chair's performance.

C. Meals

On occasion, someone may bring doughnuts or other snacks. That is not a problem. A board may decide to hold an all-day planning session once a year. Sandwiches during a working lunch or a modest working dinners, if meetings are held at the end of the workday, are appropriate. Board meetings, however, should not turn into social gatherings or banquets.

Board members often develop friendships with other board members, but those relationships are best fostered outside the boardroom. Boards are often pressed for time, but are faced with many tasks. That makes meeting time a valuable resource, not to be wasted on idle and prolonged chit chat. Several comments by Brooks strongly suggest that CIETC's meetings were more about lunch than business. Look what happened!

D. Periodic Bonuses and Supplements to Pay

Merit bonuses are permissible and may be a good management tool, but to be effective, they must be incorporated as part of a well-designed compensation system. There is evidence that the supplemental payments to CIETC executives and employees were ad hoc and made without regard to specific achievements and benchmarks. There are allegations that in one case supplemental payments were made from one grant on a "use it or lose it" basis.[15] Bonuses and pay supplements should never be made simply because there is extra money in the budget.

E. Independent Audit

The comments made regarding the independent audit are revealing. Once again, many people mistakenly believe that the purpose of the independent audit is to uncover wrongdoing and waste. It is not. The purpose of an independent audit is to confirm that the financial state-

15 Office of the Auditor of the State of Iowa, note 1, *supra*, at 22-23.

ments present an accurate portrayal of the organization's financial condition and operating results. In this case, the auditor noted what could be characterized as excessive salaries, but was provided with documentation indicating that the board through its chair had approved the expenditures.[16] Once the auditor confirms that the payments were authorized, it is not the auditor's responsibility to red flag waste or inefficiencies. That is the board's or grantmaker's responsibly.

IV. Background Material

For additional commentary, review Sections I (Setting Compensation), II (Conflicts of Interest), IV (Whistleblowers), and (V) Evaluating the Board Chair in the Background Material accompanying the case studies.

16 *CIETC Auditor Testifies: Lawmakers Criticize Kincheloe for Not Asking More Questions,* note 17, *supra.*

Case 3: Selecting Tripartite Board Members

I. Relevant Statute

Section 9910 of Chapter 106 of Title 42 to the United States Code mandates that to be an eligible entity for purposes of receiving Community Services Block Grant (CSBG) funds from a state, an organization must have a tripartite board. The U.S. Department of Health and Human Services (Office of Community Services in the Administration of Children and Families) issued Community Services Block Grant Program Information Memorandum 82 (March 23, 2005) to provide detailed guidance regarding the requirement that CSBG "eligible entities" be limited to entities with tripartite boards. Note that some small amount of CSBG grants are given to non-eligible entities that do not have tripartite boards.

Under a tripartite configuration, at least 1/3 of the members of the tripartite board must be persons chosen in accordance with democratic selection procedures to assure that those members are representative of low-income individuals and families in the neighborhood served. Each representative of low-income individuals and families selected to represent a specific neighborhood must reside in the neighborhood represented by the member.

II. Context

Many CAAs have discovered that finding board members to fill all the positions on the board can be challenging. These positions are uncompensated, meaning that those serving must do so solely out of a desire to improve their communities. This case is based on actual events, but the facts have been altered. It examines the procedures used by a nonprofit CAA to select the low-income representatives on the board. Although selection procedures do vary, there are recurring and common issues which must be addressed in formulating whatever procedures are adopted.

III. Facts

Green Community Action Agency (Green CAA) is a CAA with a $40 million annual budget. Located in a major metropolitan area, Green CAA operates a Head Start program, together with other programs aimed at assisting low-income individuals living in the community. Green CAA's board is comprised of 18 directors. One-third of the board members are elected by the community at large, 1/3 are appointed by governmental bodies, and 1/3 are elected by agencies serving the community. To qualify for election as a community representative, an individual must be 18, live in the community, and present nomination papers with 200 signatures. Write-ins are permitted.

A. One Troublesome Candidate

In a recent election, Joe was elected to Green CAA's board with just 38 write-in votes. The local newspaper reported after the election that Joe was a convicted felon (forgery). At the time of his election, Joe was charged with defrauding a bank of $17,000. He was subsequently convicted and sentenced to two years in prison. Joe insisted upon assuming his seat on the board.

B. Retention of PR Firm

Green CAA hired a public relations consultant to publicize the then upcoming election. The consultant was paid $6,300, with bonus amounts payable if certain levels of participation were achieved.

C. Nomination Papers

Only one candidate was placed on the ballot through the nomination process. Others fell short of the 200-signature requirement despite efforts to satisfy it. This meant that five of the six positions were filled by write-in candidates who received the most votes.

IV. Discussion Questions

The following questions are offered for discussion:

A. Director Qualifications

Should Green CAA amend the director qualification provision in its bylaws to exclude convicted felons from serving on its board?

1. Should the exclusion be a blanket one, or should it focus on the nature of the felony offense? The federal government's suspension and debarment rules (2 CFR Part 180) require a federal grantee to certify, among other things, that neither the organization nor its principals (which include board members) have been convicted of fraud, forgery, bribery, embezzlement, etc. within the previous three years.

2. Should the exclusion be a temporally-based one so that someone who was convicted of a crime at age 19, but who has since lived an exemplary life can serve?

3. Should someone who is convicted of a felony during their term automatically be terminated as a board member?

B. Background Checks

Should the organization's bylaws require that all candidates for director positions undergo background checks? Alternatively, should successful candidates be required to sign a statement certifying that they satisfy the requirements for a board position that are set out in the bylaws? Or should only officers with signing authority on checks, contracts etc. or other access to CAA assets be required to sign a statement? Should those officers be required to undergo credit checks before assuming their positions?

C. Staggered Terms

Should the six elected directors be divided into three classes of two directors, with 1/3 of the board coming up for election each year? Would that structure improve board decisions? How would it affect the balance of power between Green CAA's executive director and the board?

V. One Suggested Solution

A. Overview

Whenever rules don't work, those subject to them should seek change. In the case of Green CAA, the nomination procedure was not producing a sufficient number of candidates because the 200-signature requirement was too high. The idea behind the requirement was to assure that those ultimately filling the positions reserved for low-income individuals had widespread community support. That is a laudable goal, but the process for achieving it failed. A new procedure should be crafted. That might mean reducing the number of required signatures to 50, or holding a meeting in each neighborhood where those who are interested give a speech, with those attending the meeting voting for two candidates. The meeting could be conducted in conjunction with a substantive forum or similar program on a topic of interest to low-income individuals in the community. The bottom line: If a procedure is not properly working, a CAA should not hesitate to modify the procedure through changes to its bylaws, or if necessary, working with state or local authorities to make changes to laws and regulations governing the process.

B. Background Checks

Requiring background checks probably will create public relations problems. Moreover, background checks may cause some good candidates to decide against seeking a position, particularly if a person doesn't want a past problem publicly disclosed. (One possibility would be to limit background checks to the board chair and treasurer.) On the other hand, requiring each board member to sign a written statement that he satisfies the qualification requirements is probably a good idea.

C. Exclusion Based on Felony Convictions

Blanket exclusion for felony convictions is probably too broad. Many boards would probably be willing to seat a 50-year old woman who was convicted of shoplifting at age 17, but who then went to a community college, became a respected teacher, and has lived in the community for the last 25 years. On the other hand, many people would want to exclude someone who had ten successive felony convictions tied to violent crimes, particularly if the last conviction was within the last five years. Also, boards should exclude anyone who cannot sign the debarment and suspension certification.

The bylaws should establish that each board member must satisfy the membership requirements. At a minimum, members should be at least 18 years of age and be of sound mind. (Bylaws should include incapacity in examples of cause for removal.) A requirement that a board member must resign if the member is convicted of a felony during her term is appropriate, as is a requirement that each board member regularly attend meetings. Each board is likely to arrive at a unique formulation of any requirement that looks to past felony convictions as a screening device. Whatever the requirements, having them spelled out in advance assures consistent application and due process in their administration. After individuals have been selected to serve through the appropriate selection process, the board should review whether each candidate meets the minimum requirements and only after doing so, vote to seat candidates as board members. Too many boards don't focus on membership requirements. This can pose a problem if the circumstances warrant not seating a newly-elected member or removing an existing member.

D. Staggered Terms

Staggering board member terms is an excellent idea because it preserves institutional memory. The balance of power shifts to the executive director whenever there are wholesale replacements of existing board members. Then the new members cannot rely on the experience of other board members, but must look to the executive director for guidance.

For those who are unfamiliar with staggered terms or director classes, this is a widespread practice. Assuming there is not legislation or regulations providing what are conflicting requirements, a term structure is both advisable and easy to implement.

Case 4: The Board's Review of the Agency's Financial Statements

I. Context

The board of directors is responsible for monitoring the finances of the organization. This means reviewing interim financial states at each meeting (preferably monthly). Too many directors take the position that they are not accountants, investment bankers, or financial analysts, and therefore, they are unable to review the financial statements. This is nothing but laziness. Financial statements provide a quick snapshot of an organization's financial health. If the financial statements are appropriately prepared and explained, even the most unsophisticated reviewer can glean useful information with just a brief examination of the statements.

II. Sample Financial Statements

Included as part of this case study are the financial statements for Blue Community Action Agency (Blue CAA), an existing CAA. The numbers have been adjusted by a factor so as to maintain the relative relationships, but make identification of the agency more difficult. The names in the footnotes have also been changed. The statements were chosen because they were representative.

III. Questions for Discussion

The following questions are offered for discussion:

A. General

1. What should the board be looking for when it reviews the financial statements?

2. Can financial statements be used to make predictions about the upcoming year and likely financial results?

3. What is the first portion of the statement that board members should review?

4. In addition to reviewing the data as presented what else might the board review to make its examination of the financial statements more meaningful?

B. Liquidity

1. Blue CAA has $258,390 in cash as of June 30, 2006. Is that sufficient to meet its $5,663,770 in current liabilities?

2. Why does Blue CAA have a $1,067,152 cash overdraft? Does this signal a problem?

3. Is Blue CAA delinquent in payment of its mortgage? The principal balance did not change between 2005 and 2006?

4. Did Blue CAA purchase land or new buildings for the fiscal year ending June 30, 2006?

5. The liability for accrued expenses and employee withholding declined from $763,440 to $413,972 during the fiscal year ending June 30, 2006. Does this mean that Blue CAA significantly reduced its workforce?

6. For the fiscal year ending June 30, 2006, Blue CAA had $38.8 million in grant revenue? Can the agency count on this level of grant revenue during its 2007 fiscal year?

C. Expenses

1. Is there sufficient detail in the accounting for Blue CAA's expenses?

2. Would it make sense to net formula expenses against formula revenue, with only net revenue being shown?

3. Were the grant-funded assets disposed of in accordance with the grant requirements?

4. How was the valuation of in-kind expense calculated?

D. Change in Net Assets

1. How concerned should the board be that net assets declined during the fiscal year ending June 30, 2006 by $366,782?

2. What is the difference between the $366,782 decline in net assets and the $570,513 cash used by operations?

3. Is it surprising that the cash overdraft increased by $807,257 during the fiscal year ending June 30, 2006?

4. What would have happened to the overdraft had Blue CAA not reduced its draw under its line of credit by $198,333?

5. After considering these questions, what should the board ask the executive director and the CFO?

E. Audit Opinion

1. Where in the audit opinion does it say that the auditors detected no fraud?

2. What is the difference between the existence of fraud and the existence of a material misstatement in the financial statements?

3. How interested should the board be in the report by the auditors on Blue CAA's system of internal controls?

F. Notes to Financial Statements

1. Should Note 2 to the financial statements be a surprise to the board?

2. Should Blue CAA's outside legal counsel be present when the board discusses Note 2?

3. If the organization is subject to open meetings laws, can it move to closed session when it discusses Note 2?

4. Is Note 8 (discussing unemployment compensation reserves) just a technical note that only finance people need worry about? Might the board want to review Note 8 if it is considering a reduction in workforce?

5. Should the board consider purchasing its building?

6. Should the board be concerned if the executive director provides the board with Note 27 as presented here?

IV. One Suggested Solution

A. Perspective

Many board members are mystified by the organization's financial statements. They shouldn't be because they are relatively straightforward.

1. The Balance Sheet

The balance sheet is a listing of the organization's assets and liabilities. It is better to have more assets than liabilities. The balance sheet lists the assets in the order and ease that they can be converted to cash. Not surprisingly, cash, investment securities, receivables, and inventory are listed before equipment and real estate.

The balance sheet is based on historical values. As a consequence, it should not be used to assess the market value of the organization's net assets. Because of accounting conventions, cash, marketable securities, receivables, and inventory should provide a rough estimate of actual value—but recognize that the this estimate is a very rough one. The balance sheet does not reflect many important assets, including work force in place, goodwill, know-how, and going-concern value.

The balance sheet presents financial information "as of" a particular date. This is problematic. When the board receives the financial statements in March or April for the preceding calendar year, the balance sheet is already several months out of date. A lot can happen in several months.

2. The Income Statement

The income statement presents the results of operations for a particular period of time. It begins with the various sources of revenue, which can include grants, charitable contributions, fees for products and services, and investment income. The organization's expenses are then subtracted, to arrive at the net increase in assets (or in for-profit terms, net income). The net increase in assets does not equate to a net increase in cash. In fact, net assets can increase while net cash decreases.

The natural tendency of even experienced financial analysts is to view the income statement as predictive. If the organization had $1 million of grant revenue, the tendency will be to assume that next year the organization will have at least $1 million of grant revenue. Some will go so far as assume an adjustment for inflation. Both are dangerous assumptions, often proving to be faulty ones. The board should be asking management for a schedule of grants that are already in place for the current year, as well as a discussion of pending grant applications and the likelihood that those applications will result in awards to the organization.

The listing of expenses provides some sense of what type of costs the organization is incurring. For purposes of oversight, the board should be asking for a comparison between budgeted expenses and actual expenses. This will provide the board with a sense of how well management is able to control expenses and live within budgets. If the organization is consistently overspending its budget, the organization could be racking up deficits and debt that threaten its long-term viability.

3. Statement of Cash Flows

The statement of cash flows is probably the most useful, but also the most difficult to understand of the three statements. It focuses on cash provided or used by operations, investment activity, and financing. If the organization's operations are producing a cash deficit, this statement explains how that deficit is being financed. The organization may be borrowing money to cover the deficit, or it may be selling assets (investments). If the organization's operations are generating positive cash flow (surplus), the statement of cash flows explains how that cash flow is being used. Management might be investing excess cash in Treasury securities or new equipment. It also might be repaying indebtedness. This is information that the board should be keenly interested in knowing. As detailed as the statement of cash flows is (and it is arguably unnecessarily detailed), it offers the best view of the organization's financial health.

4. Notes to the Financial Statements

The notes to the financial statement are considered an integral part of the financial statements. Sophisticated financial analysts often start with the notes, which describe important assumptions underlying the numbers, supplemental information, and contingent claims such as lawsuits.

5. Auditor's Opinion Letter

Unless there has been a disagreement between management and the independent auditors, or the auditors are no longer able to rely on the assumption that the organization is a going concern, the auditor's opinion letter will be unhelpful, containing standard-form language, which basically says that the financial statements fairly represent the financial condition and results of operations of the organization, in all material respects. This is referred to as an unqualified opinion. The board should be alarmed if the organization receives a qualified audit opinion. It warrants a special board meeting or an investigation.

B. The Board's Focus

When a board reviews financial statements, it should be focused on the overall financial health of the nonprofit and the adequacy of its financial resources. One specific question the board should be asking is whether the nonprofit has sufficient liquidity to discharge its liabilities as they become due. Let's return to Blue CAA. It has almost $5.6 million in liabilities that will come due within the next year. Yet, it only has $258,390 in cash and equivalents. Should the board be concerned? Maybe not. Blue CAA also has $4.1 million in receivables, a $287,951 pledge from United Way, and $586,051 in inventories. Those assets, together will future revenue from operations, might be more than sufficient to cover maturing liabilities. Following its review of the financial statements, the board should turn to the executive director and CFO, asking about the adequacy of the agency's future revenue to meet the agencies obligations.

Blue CAA's board should pay particular attention to its statement of cash flows. The income statement shows a $366,782 decline in net assets, which can be characterized as a net loss. That should be of concern, but the statement of cash flows should cause even greater concern. It shows that operations are consuming $570,513 more in cash than they are producing. The board needs to know how this deficit is being financed. The statement of cash flows shows that Blue CAA covered a significant portion of that shortfall by borrowing $649,100. It also sold assets to raise cash. This may be a temporary problem, with a solution in sight. Or, it may evidence a long-term structural problem that needs immediate attention. Whichever is the case, the board must devote its full attention to addressing the cash flow deficit.

The notes to Blue CAA's financial statements are particularly informative. The board should already be aware of the lawsuit between Blue CAA and Lawrence Academy, but if the executive director has kept the board in the dark, Note 2 provides valuable information. The board should also focus on Note 8, which indicates that Blue CAA is self-insuring its obligations under the state's unemployment compensation system. The board must understand the risk Blue CAA is assuming.

In addition to the financial statements, the board should consider asking the CFO to prepare what are referred to as financial ratios to help the board better understand the data. For example, the board might ask the CFO to calculate the defensive interval ratio, which is equal to the agency's cash and marketable assets divided by the agency's average monthly expenses. The resulting number represents the number of months that the agency could operate without any additional revenue (ignoring liabilities). This one number is not meaningful unless it is compared to something else. The CFO might track the number over time, or she might calculate the number for similar nonprofits. If there is a sudden decrease in the number, the board has reason to be concerned. There are literally hundreds of financial ratios. The board should work with its CFO to determine the ones that are most relevant.

C. Presentation

1. Expenses

The listing of expenses in the income statement is too detailed, as counter-intuitive as that might sound. The financial statements summarize information. They are not supposed to provide the level of detail reflected in the organization's chart of accounts.

Blue CAA's financial statements do not include a statement that breaks out expenses by program. That would be more useful information for the board than all the detail presented in the income statement.

2. Restricted Categories

Generally accepted accounting principles (GAAP) require that the financial statements characterize assets and income as unrestricted, temporarily restricted, or permanently restricted. Unrestricted assets are those assets that are subject to no restrictions on how they can be used. Temporarily restricted assets are assets that have restrictions on their use which lapse either with the passage of time or upon the satisfaction of a condition (e.g., pledges are generally classified as temporarily restricted assets, as are prepaid grant funds). Permanently restricted assets are assets that are subject to restrictions that don't lapse (e.g., a fund's principal balance must be permanently invested, with only the income available for spending). The board should be concerned about restrictions because they limit the options available to the organization. For example, suppose a CAA has $2 million in cash. That sounds like a lot of cash, but if $1.8 million of that amount is restricted to use for a particular program, the organization has far fewer financial options then it would have if it could use the full $2 million without restriction.

Blue CAA's financial statements provide information about restrictions in the aggregate rather than by asset category. The board should instruct the CFO that the financial statements be prepared to identify restrictions for each asset and income category. Blue CAA's financial statements show $344,128 in permanently restricted assets, but are those restrictions on cash, or on land and buildings?

Appendix to Case 4:
The Board's Review of the Agency's Financial Statements

BALANCE SHEET **(STATEMENT OF FINANCIAL POSITION)**	June 30, 2005	June 30, 2006
Current Assets		
Cash and Equivalents	$253,007	$258,390
Revenue Receivable	$3,669,368	$4,118,118
Pledges Receivable--United Way	$289,107	$287,952
Inventories	$336,830	$586,052
Prepaid Expenses	$428,242	$502,095
Total Current Assets	$4,976,553	$5,752,607
Long-Term Assets		
Land	$89,388	$89,388
Building, Renovations, Furniture and Fixtures	$1,329,807	$1,329,807
Equipment	$657,125	$673,992
Grant Funded Assets	$3,128,782	$3,128,782
Less Accumulated Deprecations	($2,490,685)	($2,721,323)
Investments	$833,333	$833,333
Accounts Receivable—Other	$56,667	$56,667
TOTAL ASSETS	$8,580,970	$9,143,252
LIABILITIES		
Current Liabilities		
Cash Overdraft	$259,895	$1,067,152
Accounts Payable-Vendors	$2,045,067	$2,501,475
Accounts Payable-Other	$38,188	$99,115
Current Portion of LT Debt	$19,610	$15,347
Accrued Expenses and Employee W/H	$763,440	$413,972
Deferred Revenue	$375,233	$523,697
Security Deposits	$5,352	$4,060
Unemployment Compensation Reserve	$267,692	$288,953
Line of Credit	$948,333	$750,000
Total Current Liabilities	$4,722,810	$5,663,770
Long-Term Debt		
Notes Payable	$219,323	$203,163
Mortgage Payable	$1,162,833	$1,162,833
Less Current Portion	($19,610)	($15,347)
TOTAL LIABILITES	$6,085,357	$7,014,420
NET ASSETS	$2,495,613	$2,128,832
ANALYSIS OF NET ASSETS		
Unrestricted	($565,190)	($760,797)
Temporarily Restricted	$2,726,675	$2,555,500
Permanently Restricted	$334,128	$334,128
Board Designated	$83,333	$83,333
TOTAL	$2,578,947	$2,212,165

INCOME STATEMENT
(STATEMENT OF ACTIVITIES FOR THE YEARS ENDED JUNE 30, 2005 AND JUNE 30, 2006)

REVENUE AND GAINS	6/30/2005	6/30/2006
Grant Revenue	$37,457,947	$38,844,397
Program Service Fees	$316,463	$286,273
Formula Sales	$12,134,277	$12,349,662
Contributions	$1,016,018	$865,172
Interest Income	$3,318	$7,515
Program Income	$33,450	$35,223
Rent Income	$170,270	$131,095
Developer's Fee	$15,570	$27,450
Miscellaneous	$24,867	$42,433
In-Kind	$2,473,227	$2,033,520
TOTAL UNRESTRICTED Revenue AND GAIN	$53,645,407	$54,622,740
RELEASE FROM RESTRICTIONS		
Revenue	$296,843	$289,147
Depreciation on Grant-Funded Assets	$183,412	$169,980
Book Value of Disposed Grant-Funded Assets	$522,078	$0
TOTAL NET ASSETS RELEASED FROM RESTRICTIONS	$1,002,333	$459,127
EXPENSES AND LOSSES		
Salaries and Wages	$15,275,027	$14,467,420
Payroll Taxes and Fringe Benefits	$4,634,522	$4,820,070
Licenses and Inspections	$9,047	$6,747
Interest Expense	$73,407	$118,347
Bank Fees	$32,172	$27,817
Books and Reference Materials	$11,158	$5,365
Staff Development and Training	$151,373	$107,282
Legal and Professional	$58,987	$90,183
Mental Health, Speech and Hearing Consultant	$6,138	$6,203
Purchased Services and Sub-Contracting	$12,820,993	$14,580,692
Travel	$169,392	$145,442
Purchased Transportation	$60,020	$9,297
Rent	$995,030	$1,025,207
Leasehold Improvements	$33,433	$42,558
Utilities	$1,570,483	$1,600,763
Building Maintenance	$149,820	$121,887
Office Supplies	$219,012	$210,132
Cost of Formula Sold	$10,144,898	$10,522,283
Program Supplies	$419,943	$365,707

Food Purchases	$374,192	$394,782
Food Service Supplies	$75,728	$61,183
Data Processing Supplies	$31,797	$26,253
Custodial Supplies	$50,863	$64,475
Medical and Pharmaceutical Supplies	$42,532	$49,527
Training Materials	$4,063	$5,393
Weatherization Materials	$455,198	$474,238
Depreciation	$264,537	$230,638
Equipment Lease and Rental	$59,567	$69,748
Equipment Repairs and Maintenance	$58,987	$53,828
Property Taxes	$18,305	$18,825
Equipment Purchases	$86,737	$43,267
Office Fixtures and Improvements	$988	$175
Vehicle Lease	$209,288	$172,002
Vehicle Maintenance	$210,732	$234,757
Outreach Expenses	$1,270	$4,445
Insurance	$274,258	$290,188
Printing	$36,562	$35,108
Publications and Subscriptions	$29,053	$32,060
Telephone	$328,850	$327,175
Postage	$97,402	$100,420
Shipping	$676,705	$682,587
Field Trips and Parent Participation	$23,680	$22,532
Dues and Memberships	$39,090	$29,775
Advertising	$39,410	$30,838
Child Care Costs	$2,572	$1,965
Bad Debts	$1,783	$995
Miscellaneous	$28,048	$84,425
Rental Assistance	$869,283	$801,027
Energy Assistance	$244,782	$268,083
Emergency Food Assistance	$309,082	$315,460
In-Kind	$2,473,227	$2,033,520
TOTAL EXPENSES AND LOSSES	$54,253,425	$55,233,095
INCREASE (DECREASE) IN UNRESTRICTED NET ASSETS	$394,315	($151,228)
CHANGES IN TEMPORARILY RESTRICT NET ASSETS		
Grant Revenue	$85,770	$0
Contributions	$289,107	$287,952
Net Assets Released from Restrictions	($1,002,333)	($459,127)
(DECREASE) IN TEMPORARILY RESTRICTED NET ASSETS	($627,457)	($171,175)
CHANGE IN PERMANENTLY RESTRICTED NET ASSETS	$0	$0

(DECREASE) IN NET ASSETS	($233,142)	($322,403)
PRIOR PERIOD ADUSTMENTS	($522,078)	($44,378)
(DECREASE) IN NET ASSETS	($755,220)	($366,782)
NET ASSETS BEGINNING OF THE YEAR	$3,250,833	$2,495,613
NET ASSETS END OF THE YEAR	$2,495,613	$2,128,832

STATEMENT OF CASH FLOWS FOR THE YEARS ENDED (JUNE 30, 2005 AND JUNE 30, 2006)

	6/30/2005	6/30/2006
CHANGE IN NET ASSETS	($233,142)	($322,403)
		$0
ADJUSTMENTS TO RECONCILE CHANGES IN NET ASSETS TO NET CASH PROVIDED BY OPERATIONS		$0
Depreciation	$264,537	$230,638
Prior Period Adjustment	($522,078)	($44,378)
(Increase) Decrease In:		$0
Revenue Received	($503,138)	($448,750)
Pledges Receivable--United Way	$7,737	$1,155
Inventories	$186,627	($249,222)
Prepaid Expenses	$83,950	($73,853)
Increase (Decrease)		$0
Accounts Payable—Vendors	($285,605)	$456,408
Accounts Payable—Other	($83,595)	$60,927
Accrued Expenses and Employee Withholdings	$74,077	($349,468)
Deferred Revenue	$32,733	$148,463
Security Deposits	($20)	($1,292)
Unemployment Compensation Reserve	($2,303)	$21,262
NET CASH (USED) BY OPERATING ACTIVITIES	**($980,222)**	($570,513)
		$0
CASH FLOW FROM INVESTING ACTVITIES		$0
Property and Equipment Acquisitions	($85,753)	($16,867)
Book Value of Disposed Grant-Funded Assets	$522,078	$0
NET CASH (USED) BY INVESTING ACTIVITIES	**$436,325**	($16,867)
		$0
CASH FLOW FROM FINANCING ACTIVITIES		$0
Payments on Long-Term Debt	($13,827)	($16,160)
Increase (Decrease) in Line of Credit	$775,000	($198,333)
Increase (Decrease) in Cash Overdraft	($112,073)	$807,257
NET CASH PROVIDED BY FINANCING ACTIVITIES	**$649,100**	$592,763
		$0
NET (DECREASE) IN CASH	**$105,203**	$5,383

SELECTED NOTES TO THE FINANCIAL STATEMENTS

NOTE 1

The Organization is a nonprofit corporation which provides assistance to low-to-moderate income individuals and families in Blue County of the State of Apple, despite their inability to pay. The Organization operates a variety of programs including, but not limited to, Head Start, Child Care Services, Abused Family Shelter, Job Training, Energy Assistance, Child Daycare, Senior Centers, and Formula Distribution. The Organization's programs are funded by various federal, state, and local grants, allocations, and private donations.

The Organization accounts for contract and grant revenue, which are exchange transactions, in the statement of activities to the extent that expenses have been incurred for the purpose specified by the grantor during the period. In accounting for such revenue, the legal requirements of each individual program are used as guidance. All funds not expended in accordance with the grant or contract are recorded as a liability to the grantor as the Organization does not maintain any equity in the grant or contract. Additionally, grant and contract funds received in advance of their proper usage are accounted for as deferred revenue in the statement of financial position.

NOTE 2

The Organization and Lawrence Academy are in dispute over their services contract. On March 5, 2006, the Organization filed a lawsuit in the district court against the Lawrence Academy for breach of contract. The amount in dispute as of June 30, 2006 included in grant revenue and revenue receivable totals $881,960. As of March 6, 2007, a settlement had not been reached, and the Organization's counsel has advised they expect this case to proceed to trial in Winter 2008. In April 2007, the Lawrence Academy counter-sued by expanding the dispute to include a total of $2,995,828 in billings dating back to 1999. The Organization's counsel has advised their evaluation of the outcome is that it is probable that the Organization will prevail. Accordingly, no provision for bad debt has been made in these financial statements

NOTE 4

Inventories as of June 30, 2006 and June 30, 2005 consist of the following:

	June 30, 2006	June 30, 2005
Description		
Weatherization Materials	$ 55,192	$ 35,482
WIC Formula Warehouse	$ 530,860	$ 301,348
Total Inventories	$ 586,062	$ 336,830

NOTE 8 - UNEMPLOYMENT COMPENSATION RESERVE

Effective January, 1989 the Organization elected to reimburse the State of Apple Unemployment Compensation Fund for actual unemployment compensation claims paid. For the years ended June 30, 2006 and June 30, 2005, contributions were made to the reserve at the rate of 4.0% of gross salaries, When employees receive unemployment compensation, the Unemployment Compensation Fund is reimbursed for the amount of the payment and the Organization's unemployment compensation reserve is reduced accordingly. To obtain this method of providing for unemployment compensation, the Organization was required by the state to put up as collateral a passbook savings account which has been pledged to the state, The balance in the savings account at June 30, 2006 and 2005 is $36,343 and $36,343 respectively. The balance of the Organization's unemployment compensation reserve at June 30, 2006 and 2005 is $288,953 and $267,692 respectively.

NOTE 9 - LONG TERM DEBT

Maturities of long-term debt for each of the next five years are as follows:

Year Ended	
June 30, 2007	$ 15,347
June 30, 2008	$16,828
June 30, 2009	$18,453
June 30, 2010	$20,233
June 30, 2011	$22,107
Thereafter	$1,272,948

NOTE 13 - PERMANENTLY RESTRICTED ASSETS

Permanently restricted net assets represent $334,128 in funding received from the the State of Apple Department of Human Services to purchase the initial WIC formula inventory. These funds are permanently restricted for inventory.

NOTE 18 - LINE OF CREDIT

The Organization has available an unsecured line of credit of $1,833,333 at the Five Spot Bank at the LIBOR rate. The rate at June 30, 2006 was 7.79%. The balance as of June 30, 2006 and June 30, 2005 was $750,000 and $948,333 respectively.

NOTE 22 - LONG-TERM LEASES

The Organization has entered into five long-term property leases as of June 30, 2006. The leases have monthly payments ranging from $6,938 to $83,128. These leases will expire from April 30, 2007 through December 31, 2021. Property rents totaled $2,107,355 for the year ended June 30, 2006. Future minimum annual property lease payments are as follows:

June 30, 2007	$2,132,357
June 30, 2008	$2,085,203
June 30, 2009	$2,092,078
June 30, 2010	$1,624,502
June 30, 2011	$1,393,001
Thereafter	$11,531,866
Total	$20,859,008

NOTE 26 - GROSS PROFIT FROM FORMULA SALES

Gross profit from sales is summarized below:

	2006	2005
Formula Sales (Including shipping and handling fees charged to customers)	$12,349,662	$12,134,277
Less: Cost of Sales (Including shipping and freight expenses)	$11,204,870	$10,821,153
Gross Profit from Sales	$1,144,792	$1,313,123

INDEPENDENT AUDITOR'S UNQUALIFIED OPINION

TO: THE BOARD OF DIRECTORS

We have audited the accompanying statements of financial position of Blue Community Action Agency (Blue CAA) as of June 30, 2006 and 2005 and the related statements of activities and cash flows for the years then ended. These financial statements are the responsibility of Blue CAA's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in Government Auditing Standards, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Blue CAA as of June 30, 2006 and 2005, and the changes in its net assets and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

In accordance with Government Auditing Standards, we have also issued a report dated February 23, 2007 on our consideration of Blue CAA's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of this report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with Government Auditing Standards and should be read in conjunction with this report in considering the results of our audit.

Our audit was performed for the purpose of forming an opinion on the basic financial statements of Blue CAA taken as a whole. The accompanying schedule of expenditures of federal awards on pages 32 to 39 is presented for purposes of additional analysis as required by the U.S. Office of Management and Budget Circular A-133, Audits of States, Local Governments, and Non-Profit Organizations, and is not a required part of the basic financial statements. Such information has been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, is fairly stated, in all material respects, in relation to the basic financial statements taken as a whole.

Signed,

Auditor

Case 5: The Board's Review of the Management Letter

I. Context

Boards frequently are told that they must oversee the adequacy of a nonprofit's internal and financial controls, but rarely are boards told how to monitor the adequacy of those controls. The standard form audit opinion issued by the independent auditors adds nothing to the board's understanding of the organization's controls. What many directors don't know is that the auditors provide management with a letter discussing problems that the auditors detected during the audit. These problems include inadequacies in the system of internal controls.

Although the letter is referred to as a management letter, it should be reviewed by the board and its audit committee. The board's audit committee should then work with management to develop a plan that corrects control deficiencies. The board is not charged with developing or implementing the details, but it should make sure that management either corrects the problems or retains consultants who can implement the necessary fixes.

II. Facts

A. Background[1]

Opportunities Industrialization Center of Greater Milwaukee ("OIC-GM") was a non-profit organization established in 1967 that operated a broad range of programs and services that fell into following two basic categories: (i) comprehensive job training and skills development programs for low-income people; and (ii) economic and neighborhood development initiatives targeted towards Milwaukee's central city community.[2] In 1997, the Wisconsin Department of Workforce Development selected OIC-GM to deliver services in Milwaukee County under Wisconsin's then newly-created Wisconsin Works (W-2) program, Wisconsin's innovative effort to replace its traditional welfare program (Aid to Dependent Families with Children) with a program that links work and subsistence payments.[3] During the ensuing period, OIC-GM entered into contracts with the State of Wisconsin valued at $247 million.[4] By 2004, OIC-GM was responsible for providing services to approximately 50% of the W-2 participants in Milwaukee County, which was approximately 40% of the caseload in Wisconsin. In short, OIC-GM's funding and activities were tightly linked to the State of Wisconsin.

1. Kickback Scheme

Given OIC-GM's prominence, news that some of those associated with it were the subject of a criminal investigation related to a kickback scheme grabbed the headlines in Milwaukee's leading newspaper, the Milwaukee Journal-Sentinel.[5] The details are a bit murky because of plea agreements, but when all the dust settled, a Wisconsin state senator was indicted on charges of participating in a kickback scheme

1 The background material is taken from material previously prepared by Jack Siegel. He retains his copyright in the material, but has provided CAPLAW with permission to use it.

2 Steve Schultze and Leonard Sykes, Jr., *Embattled OIC to Close Its Doors*, Milwaukee J. Sentinel, Feb. 10, 2005.

3 Steve Schultze, OIC *Loses More of Its W-2 Contract: State Takes Away Another $10.1 Million and 2,000 Clients*, Milwaukee J. Sentinel, Dec. 9, 2004.

4 Steve Schultze, *W-2 Firm Under Close Watch: Fate of Agency's Contract Lies in Findings of State Auditor, Monitor*, Milwaukee J. Sentinel, Jan. 6, 2004.

5 Georgia Pabst, *Indictment of Agency Leader Surprises Some: Friends Say Offering Kickbacks Would be Unlike Gee*, Milwaukee J. Sentinel, Mar. 22, 2004.

involving a prominent attorney who represented OIC-GM. According to a January 22, 2004 article in the Journal-Sentinel, the state senator pled guilty to "a single count of conspiracy to accept kickbacks of legal fees paid by the [OIC-GM]," with four unrelated counts being dismissed.[6]

2. Conspiracy

In August 2004, a jury convicted the longtime head of OIC-GM of conspiracy for his involvement in the kickback scheme involving the state senator.[7] The conspiracy also involved the purchase by OIC-GM of an interest in a Virgin Islands television station controlled by the state senator's family.[8] OIC-GM never received the stock certificates evidencing its ownership interest. Following the conviction, two OIC-GM affiliates were criminally indicted by the Federal prosecutor, allegations circulated about a questionable real estate transaction, and other allegations were made about misuse of W-2 funds.[9]

3. Underlying Problems Revealed

During 2003 and 2004, numerous articles appeared in the Journal-Sentinel that portrayed OIC-GM (and its affiliates) as a deeply troubled organization, with poor governance. The depth of the problems was not reflected in the criminal prosecution, which relied on plea bargains that effectively curtailed a full airing of the facts

However, headlines in the Journal-Sentinel toward the end of 2004 and beginning of 2005 provided insight into the public relations problems that followed a year of scandal. Among the headlines were the following: (i) OIC May Not Receive New Funds for '05: Common Council Advised to Withhold Block Grant Money; Incomplete Projects Cited;[10] (ii) George Kin Aboard OIC Gravy Train;[11] (iii) OIC Loses More of Its W-2 Contract: State Takes Away Another $10.3 Million and 2,000 Clients;[12] (iv) OIC Attempts to Steady Itself Amid Whirlwind of Scandal: Agency Struggles with Big Deficit, Poor Morale and Criminal Probes;[13] (v) OIC Laying Off 130: Third of Staff to Go as Agency's Funding Slashed;[14] (vi) OIC Board Resigns as Affiliations End;[15] (vii) Former Welfare Execs' Pay Total in Millions;[16] (viii) Subcontractors Say OIC Owes $655,000 Plus For Weatherization;[17] (ix) OIC Draws More Fire;[18] and (x) Audit Uncovers Widespread Problems at OIC.[19]

An audit was performed by a new accounting firm once the scandals reached crisis proportions. This audit is particularly interesting because it details internal control lapses, including one deficiency that permitted an employee to allegedly continue paying aid to W-2 program

6 Graeme Zielinski, *George Pleads Guilty to Fraud: Four Other Counts Dismissed; Ex-Senator to Cooperate*, Milwaukee J. Sentinel, Jan. 22, 2004.
7 Derrick Nunnally, *Jury Finds Gee Guilty in Kickback Scheme: George Associate Secretly Directed Money to Ex-Senator*, Milwaukee J. Sentinel, Aug. 19, 2004.
8 *Id.* See also Bruce Murphy, *Investment Leads to Legal Troubles*, Milwaukee J. Sentinel, May 30, 2004.
9 Gina Barton, *2 Former Affiliates of OIC Sentenced*, Milwaukee J. Sentinel, July 21, 2005.
10 Georgia Pabst, Milwaukee J. Sentinel, Oct. 29, 2005.
11 Cary Spice and Dan Bice, Milwaukee J. Sentinel, Nov. 13, 2004.
12 Steve Schultz, Milwaukee J. Sentinel, Dec. 9, 2004.
13 Steve Schultz, Milwaukee J. Sentinel, Dec. 12, 2004.
14 Steve Schultze, Milwaukee J. Sentinel, Dec. 20, 2004.
15 Steve Schultze, Milwaukee J. Sentinel, Jan. 14, 2005.
16 Steve Schultze, Milwaukee J. Sentinel, Nov. 12, 2004.
17 Steve Schultze, Milwaukee J. Sentinel, Jan. 7, 2005.
18 Steve Schultze, Milwaukee J. Sentinel, Jan. 28, 2005.
19 Steve Schultze, Milwaukee J. Sentinel, Feb. 1, 2005.

beneficiaries after they were no longer eligible for benefits. Many of the articles contained angry comments from state and local elected-representatives.

4. OIC Closes

On February 10, 2005, the Journal-Sentinel reported that the OIC-GM board had voted to shut the agency down. Subsequent articles reported that the State of Wisconsin essentially took over the agency to protect its interests. A February 14, 2005 article is headlined At OIC, Who to Blame is All that Remains: Politicians, Insiders Are All Under Scrutiny. Surprisingly, the article never mentions the board of directors, nor do many of the other articles or people quoted in them.

B. OIC's Management Letter

The management letter[20] from the independent auditors who were brought in once OIC was in crisis pointed out the following deficiencies in OIC-GM's system of internal controls (the language, but not the headings are taken directly from the letter):

1. Inaccurate Reports

During 2003, prior management provided the Finance Committee with a "Report of Financial Activity." This report is a narrative explanation of comparisons with budget and other matters. However, due to the subsequent recording of numerous adjustments, the financial information provided was not an accurate reflection of the financial position or results of operations. Management needs to implement procedures to ensure that future financial statements provided to the Board of Directors are reflective of the Organization's current financial performance.

2. Multiple Accounts

Opportunities Industrialization Center of Greater Milwaukee Inc.(OlC-GM) has over 30 separate cash accounts for its programs and related entities. This has caused the record keeping and reconciliation process to become very cumbersome. Some of the bank accounts were not reconciled in a timely manner. Management should consider reducing the number of cash accounts.

3. Irregular Entry of Data

Prior management was still posting numerous internally generated journal entries to OIC-GM's records for December 31, 2003 during the 4th Quarter of 2004. Management needs to implement procedures to ensure that the general ledger is reconciled on a timely basis throughout the year.

4. Irregular Account Reconciliation

Amounts due to/from various related entities have not been reconciled on a regular basis nor have the accounts been settled. Management should reconcile on a monthly basis and then settle the balances on a periodic basis.

5. Overly Complex System

The general ledger structure is very detailed and involves hundreds of interfund and intercompany accounts. Management needs to re-evaluate the need for all the interfund accounts and should develop procedures to minimize the use of these accounts.

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20 Virchow, Krause & Company, LLP, *Management Letter Directed to OIC-GMs Board of Directors*, Dec. 15, 2004. The letter was provided to Jack Siegel by the State of Wisconsin.

6. Internally Inconsistent Data

Subsidiary ledgers for payable and receivable did not agree to the general ledger at the start of the audit. The subsidiary ledgers need to be reconciled to their corresponding general ledger accounts on a monthly basis.

III. Questions for Discussion

The following questions are offered for discussion:

A. Would a better accounting system have detected the kickback scheme sooner, or even prevented it?

B. Was the board receiving accurate financial information at its regularly-scheduled board meetings?

C. Assuming the board had no financial experts as members, what should it have done when it received this letter?

D. How should a board respond if management refuses to make the changes or ignores the board?

E. Is it likely that the State of Wisconsin's decision to effectively close OIC-GM was influenced by the management letter?

F. The management letter was produced partly in response to a crisis. Would this firm have provided the same letter had there been no crisis?

IV. One Suggested Solution

A. General Comments

This letter is damning, which should be apparent to even to the most financially unsophisticated board member. It basically said that the accounting system was a mess, incapable of producing accurate financial statements. A board simply cannot ascertain whether an agency has sufficient financial resources or whether a financial crisis looms unless it has accurate and timely financial statements. Assuming for the moment that the OIC-GM board reviewed interim financial statements at its regular meetings, it is doubtful whether the statements the board was reviewing were accurate given the failures to reconcile accounts and the inconsistencies in data stored in and reproduced by the accounting system.

There are indications that OIC-GM's board received summaries of financial information rather than the actual financial statements. Management summaries and analysis is perfectly appropriate, but only if each board member is provided with a complete set of financial statements.

B. Preventing Kickbacks

The kickback scheme was what first brought OIC-GM into the public spotlight, but a better accounting scheme would not necessarily have led to earlier detection. A kickback scheme requires collusion, making it one of the most difficult types of fraud to detect. Moreover, legal fees are notoriously open-ended. Even had the specific problems that were identified by the auditors never existed, there is still a strong possibility that the kickback scheme would have unfolded as it did. Nevertheless, those problems were probably indicative of other ones. For example, did OIC-GM use competitive bidding when procuring legal services? Did the board ever compare the actual bills against budgeted amounts? Did OIC remit its payments to the lawyer performing the services, or to his law firm's accounting department? In short, a detailed and well-thought out system of internal controls is necessary to detect and prevent fraud. Even then, no system is foolproof.

C. Audit Committee or Expert

Even financial neophytes who review a letter like the OIC-GM management letter should know that the nonprofit has serious problems. At first, the board might feel like a deer caught in headlights, but help is always available. The board or its audit committee should demand a meeting with the auditors. Management should be excluded from that meeting. The auditors should be asked what course of action they recommended. In theory, the board can instruct management to proceed with the fix, requiring management to report back to the board or its audit committee with regular progress reports. Any board faced with the sort of accounting system that OIC-GM's board encountered should have serious reservations about management's ability to fix the problems. In fact, a strong case can be made that the first step is to replace the CFO and possibly the executive director, as well as accounting personnel.

Case 6: The Board Review of Certain Transactions

I. Context

Boards must walk a fine line. On the one hand, outsiders are quick to criticize a board when it fails to review a major transaction if the transaction subsequently is identified as one posing a conflict of interest or fiscal improprieties. On the other hand, if the board reviews the monthly phone bills or every expense reimbursement, it is viewed as overstepping its oversight function. It is meddling.

II. Facts

The following case study is based on actual events, but the facts have been altered. With an annual budget exceeding $50 million,[1] Yellow Community Action (Yellow CAA) operated one of the larger anti-poverty programs in the nation. Several years ago, the agency and its board came under scrutiny because of a series of transactions. One of the agency's principal funders questioned a number of those transactions in a report (Report)[2] that was subsequently provided to Yellow CAA's board. At the time of the crisis, Yellow CAA had a 40-member board, which included several lawyers and a senior-vice president at a large bond rating agency. At least 70% of Yellow CAA's came from federal and state grants. Its executive director had headed the agency for 16 years, receiving $145,000 in annual compensation two years prior to the crisis. The Report concluded that Yellow CAA was overspending, which will likely result in serious cash flow problems

The following are some of the transactions described in the Report:

A. Non-Conflict of Interest Transactions

The purchase of a $800,000 luxury beach house. Yellow CAA had rented the house for outings by the board, as well as by victims of domestic violence. The proposed purchase was precipitated by an apparent desire to expand the number of outings. The executive director paid $250,000 toward the house's purchase without board authorization.

1. In one month, staff members ran up somewhere around $24,000 in cell phone charges. The Report and media accounts are not clear, but the implication is that this was not unusual.

2. A $800,000 contract with a low-income housing consultant for the development of a prototype apartment building for low-income individuals. At the time of the Report, the prototype was only 20% complete. The consultant contended that he was paid considerably less than the $800,000 amount.

3. A $300,000 consulting contract with someone who the Report concluded should have been

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1 Specific numbers and facts have been altered because this agency still exists. However, the altered facts reflect the circumstances that resulted in the problems.

2 What is referred to as the Report may actually have been two reports. Newspaper accounts refer to a report by independent federal investigators. For purposes of preparing this case study, I reviewed a report by a CSBG office. It covers much of the same ground as the report described in the newspaper articles, but with a greater focus on recommended changes in governance and control than is reflected in the articles.

classified as a full-time employee. The report did not fix the term of the consulting contract or the reason for the arrangement.

B. Conflict-of-Interest Transactions

1. A no-bid contract for insurance services with a company owned by a board member.

2. The rental of space to a company owned by a board member.

3. A $150,000 loan to a nonprofit — the executive director sits on that nonprofit's board and its executive director sits on Yellow's board. The Report indicated that only $30,000 of the loan had been repaid. It concluded that the remaining portion of the loan may have been forgiven.

4. The board president had access to a 2005 Porsche 911 GT2. Yellow CAA's bylaws specifically prohibited board members from receiving compensation for their board service.

C. Executive Director Transactions

1. The executive director racked up $220,000 in charges on two AMAX credit cards. There was no documentation to support many of those charges. The person who replaced the executive director claimed that he had uncovered statements for $170,000 of expenditures, which included meals, concerts, theatre, and other entertainment events.

2. The executive director also had the use of two Hummers.

III. Discussion Questions

The following questions are offered for discussion:

A. Should all transactions involving conflicts of interest be prohibited?

B. If there is not a blanket prohibition against conflict-of-interest transactions, should the board be required to review all such transactions?

C. Should the executive director be serving on another nonprofit board, particularly if the other nonprofit's executive director serves on Yellow's board?

D. Are no-bid contracts ever appropriate?

E. Is there a threshold (percentage or dollar amount) that should trigger a mandatory review by the board of a transaction (assume the transaction does not pose a conflict of interest)?

F. Should the board monitor the executive director's expense account? If so, how?

G. Is it good practice to make a personal car available to the executive director?

H. Is it ever appropriate for a CAA to make a non-program related loan?

IV. One Suggested Solution

A. Conflicts of Interest

If at all possible, CAAs should avoid conflicts of interest. Sometimes this is not possible, but that should be the rare case. When it comes to the procurement of basic products and services, there are often many providers. Where possible, the CAA should strive to procure legal, accounting, security, insurance, administrative, facilities repair and management, financial, and other commodity-type services from independent third parties. (Indeed, under new Head Start legislation, CAAs that run Head Start programs will now be required to avoid conflict of interest transactions with board members.) The board should not view contracting as a means for rewarding a volunteer board member for her service.

1. The Policy

Most experts believe that an organization should have a conflicts-of-interest policy. This is only partially true. An organization might as well not have a conflicts-of-interest policy if it merely adopts a policy that someone finds on the Internet. To be meaningful, a policy must reflect the organization's values and unique circumstances. That means that the board should spend considerable time crafting a policy before adopting it.

2. Affirmation and Compliance

To be meaningful, the policy should be distributed to all board members, employees, and contractors. Once a year, each of those individuals should be required to sign a statement indicating that they have read the statement and agree to abide by its terms. The policy should define the consequences from violating it. The policy should also have clearly defined procedures for bringing conflicts to the attention of the person or committee who is charged with vetting them.

B. No-Bid Contracts

Obtaining bids for contracts is appropriate and often required by the terms of grants. Barring specific legal requirements, an organization should not be required to obtain a bid for every contract it enters into. For example, a plumbing fixture may develop a leak (assume not an emergency). The office administrator may have a plumber that he has worked with in the past. If the cost of repair is under a threshold amount (e.g. $500), it simply may not be worth obtaining bids.

The board should define the types and set thresholds for contracts that don't require bids. It should not set one threshold amount that applies to all contracts. Construction contract thresholds might differ from those applied to contracts with professional service providers and consultants. Moreover, some types of services should be procured through a bid for services over a period of time. For example, an organization contracting for audit or legal services might consider asking for a bid based on a three- or five-year relationship. Finally, bids should not necessarily be awarded to the low-cost bidder. Not all services providers offer the same quality services or the same level of dependability. There are cases where paying a premium for knowledge and experience is warranted.

C. Board Review of Transactions

Deciding when the board should review a transaction is a difficult question. If an organization with a $5 million budget is considering building a new headquarters building or issuing a

$4 million tax-exempt bond, the board should review and approve the transaction. It should also review a grant contract if the contract comprises a significant portion of the organization's funding. However, the board should not be reviewing contracts for a $5,000 remodeling job, or for a new administrative assistant, assuming the new position is factored into the budget and that the person hired is not closely related to a board member or key staff member.

The board should also instruct the executive director that it wants to review and approve all transactions that pose appearance issues. In the case of Yellow CAA, the cost of the $800,000 beach house equals only 2% of the agency's annual budget. Nevertheless a luxury beach house raises appearances issues, particularly when it is used for board outings. As a general rule, Yellow CAA's board might require its review of all transactions that exceed 10% of the annual budget, but it should consider requiring its prior approval for any transaction that raises appearances issues.

D. Board Membership

Interlocking board memberships are troublesome because they could result in what is termed "backscratching." Yellow's executive director has a natural advocate on Yellow's board, that person being the executive director of the other nonprofit. That executive director is likely to support proposals put forth by Yellow's executive director out of the hope that Yellow's executive director will do likewise while serving as a board member of the other nonprofit. This could be particularly problematic if the other executive director serves on Yellow's compensation committee. There may be legitimate reasons why Yellow's executive director should serve on other nonprofit boards, but such service must not compromise oversight by Yellow's board.

E. Policies as a Means of Control

Yellow CAA and its employees engaged in a number of transactions that were inappropriate. Cell phone and credit card charges were found to be out of control and often unsupported by documentation. Credit card charges included tickets to concerts and other entertainment events. There also was a January trip by board and staff members to Mexico City for a conference.

A board should not review all credit card expenditures, but it should implement policies defining who is eligible for a corporate credit card and the level of documentation and pre-approval that is required for travel, training, and entertainment. The executive director presents a unique problem because all employees report to him, making pre-approval and review of documented expenses difficult. Here the board may want to consider having the compensation committee periodically conduct a review of the executive director's expenditures. The board's audit committee should review expenses incurred by the board in an effort to make sure that they are appropriate.

F. Automobiles

As a general rule, nonprofits should think twice before providing cars to their executives as a form of compensation. This is particularly true of social services agencies. The executive director can buy his own car, and if the car is used for business, he can be reimbursed through a mileage allowance. Cars create appearances problems, particularly when the car is a Porsche, Mercedes, Lexus, high-priced SUV, or some other highly-coveted and expensive vehicle. The one possible exception to this admonition might be for the executive director of a rural CAA or other CAA where driving for business purposes (and not just commuting) is a significant and necessary part of the job. Her job may require several hundred miles of weekly travel, making an agency-provided car both practical and appropriate, but only if the executive director limits her use to business,

or reimburses the agency for personal use. Under no circumstances, should the car be a luxury automobile.

V. Background Material

For additional commentary, review Section III (Conflicts of Interest) of the Background Material accompanying the case studies.

Case 7: Social Entrepeneurship and Conflicts of Interest

I. Context

The hot trend in philanthropy is social entrepreneurship, a term with ambiguous meaning. Advocates of this trend know that they want to do more than distribute cans of food to the poor or provide direct energy assistance to low-income homeowners and renters. This has led to a number of creative partnerships between nonprofits and for-profit entities. Although the resulting enterprises can be exciting and innovative, they also pose governance issues for the nonprofit partners, particularly when the nonprofit's directors and employees hold an ownership interest in the enterprise.

This case study looks at social entrepreneurship. Although the facts are fictional, they are loosely based on a number of enterprises that do exist.

II. Facts

Grey Community Action Agency (Grey CAA) operates Head Start, weatherization, nutrition for the elderly, energy assistance, and a number of other programs in a predominantly Latino neighborhood located in a major metropolitan area. It also operates an afterschool program for middle and high school students, providing them a place to go afterschool to do their homework, participate in sports and arts activities, and enjoy a healthy snack. Marta Delgado is Grey CAA's executive director. Delgado had a brainstorm shortly after returning from a conference on social entrepreneurship in Los Angeles. Larry Wilcox, one of her board members is a No Sweat franchisee, a business that provides afterschool college preparatory services to wealthy high school students throughout the country. Delgado decided to approach Wilcox about partnering with Grey CAA to open a No Sweat program to serve low-income students.

Delgado and Wilcox having been talking about the idea for the last several months. Wilcox is convinced that No Sweat will be willing to provide a franchise for the Latino community if Grey CAA is willing to provide 49% of the necessary capital. He has proposed that he and Delgado provide the remaining 51% of the capital in exchange for a 51% interest in the venture. He believes that No Sweat will be willing to offer the franchise at a 60% reduction in the fee that the franchisee must pay because No Sweat's founder has expressed an interest in helping low-income youth with the profits that No Sweat has earned from the families of wealthy high school students.

Wilcox has suggested that the program operate on just Saturdays and Sundays because Grey CAA's afterschool facility goes unused on the weekends. He also has suggested that No Sweat hire some of the teachers and aides from those public school teachers and staff members who supervise the afterschool program. The teachers provide their services in the afterschool program on a volunteer basis and the aids are paid $10 to $15 per hour. The opportunity to earn some extra money on the weekends would be a good way to reward for these individuals. The preliminary financial projections for the proposal estimate that teachers in the program will be paid $35 an hour and the aides will receive $20 per hour.

A. Structure

The proposal calls for the following structure. No Sweat will operate as a limited liability company. Grey CAA will have a 49% ownership interest, and Delgado and Wilcox will each hold 25.5% interests.

B. Board Approval and Opening

Delgado and Wilcox work on the plan for several months before taking the idea to Grey CAA's board. Delgado is both excited at the prospect of helping kids in her community better prepare for college and a little apprehensive about the $50,000 mortgage loan she will have to take out on her home to fund her share of the investment.

After several special board meetings, the board votes 16 to 9 in favor of making the investment. Six months later, No Sweat facility opens to great enthusiasm from the community. The $40 weekly fee is admittedly high for some families, but it is only 20% of the fee charged to students at other No Sweat facilities. Grey was able to obtain a special grant from the state to provide scholarships for 20% of the students participating in the weekend program. Those board members who initially had reservations had to admit this was an excellent idea given the community's overwhelmingly positive response.

C. Two Years Later

With waiting lists to participate in the weekend program, it is hard to imagine any problems with the No Sweat initiative, but unfortunately they have surfaced, including the following ones:

1. Trouble Staffing the Afternoon Program

Grey CAA has had to cut enrollment in its afternoon program by 35% due to staff shortages. Although several volunteers in the afternoon program were enthusiastic about the opportunity to earn a little extra money, they soon discovered that they just didn't have the time to spend with their families. To correct the problem, the volunteers significantly cut back on the hours they devoted to the afterschool program.

2. Unfavorable Audit

The state CSBG office determined that No Sweat was not paying sufficient rent for use of the facility on the weekend. The auditors also objected to the fact that No Sweat was named as an insured on Grey CAA's general liability policy, but provided no reimbursement for its share of the premium. Delgado argued that the amount to be reimbursed was factored into the rent. The auditors were also concerned that No Sweat routinely used computers that had been provided for the students in the afterschool program without reimbursing Grey CAA.

3. Delgado's Response

Delgado pointed out to the board that the No Sweat facility has proved to be a worthwhile project for Grey CAA. It had already received $10,000 on its investment, as well as greater participation by members of the community in its other programs. She also told the board that use of the computers was in furtherance of Grey CAA's mission of assisting young people living in the community so the auditors were likely to back off their demand that No Sweat reimburse Grey CAA for its use of the computers.

4. Enrique Rayo's Response

Enrique Rayo, who has been a member of Grey CAA's board for over a decade, always objected to the No Sweat proposal. He believed it posed serious conflicts of interest for Delgado and would prove to be a distraction. Rayo wants to see the audited financial statements for No Sweat, but Delgado claims that this not necessary. She and Wilcox have decided not to make the statements available because they don't want outsiders to understand No Sweat's cost structure.

III. Discussion Questions

The following questions are offered for discussion:

A. Should CAAs limit their activities to providing traditional social services, or should they look to more entrepreneurial business enterprises to improve the lives of low-income people?

B. What factors should a CAA consider when it is deciding whether to embark on a nontraditional program or partnering with a for-profit entity?

C. Should Grey CAA's board have approved the arrangement with Delgado, or should it have prohibited all Grey officers, directors, or employees from participating as investors in the venture and retained total ownership and control over the franchise?

D. Assuming Grey agreed to permit Delgado to participate, what provisions should it have required in the operating agreement and other organizational documents to protect its interests?

E. If Grey CAA's program participants were benefiting from the program, must Grey CAA nevertheless receive fair market value rent for the use of its facilities and must it be reimbursed for insurance, computer usage, and other benefits that are provided to No Sweat through joint use of facilities?

F. Are there any tax ramifications to this arrangement?

IV. One Suggested Solution

A. CAA as a Social Entrepreneurs

There is no correct answer to the question as to whether CAAs should act as social entrepreneurs. Many CAAs prefer to focus on traditional programs to serve low-income individuals, including Head Start, Weatherization, energy assistance, elder and child nutrition, and counseling, among other services. Others have chosen to add what might be characterized as innovative or exotic projects to their program portfolios. Both approaches can make significant differences in the lives of low-income individuals if properly administered.

No doubt each CAA board will arrive at a slightly different approach when it comes to social entrepreneurship. The board must be actively involved in the decision process whatever the approach. The sort of philosophical questions that surround social entrepreneurship are exactly the questions that boards are tasked with asking.

B. Approving the Arrangement with Delgado

Grey CAA's board should have rejected the arrangement with Delgado, but not necessarily the idea. Delgado had a clear conflict of interest. Once she had an ownership interest in No Sweat, her financial interests would inevitably lead her to favor No Sweat over other CAA programs should there be conflicting choices. This does not mean Delgado is an evil person, just a person who is subject to human nature.

Recall that some volunteers stopped working in the afterschool program once they were provided with an opportunity to make money through No Sweat. One could blame both Delgado and the board for not anticipating this possibility, but there are only so many problems that decisionmakers can anticipate. Once the problem became apparent, why didn't Delgado make continued participation in the afterschool programs a condition to participating in the financially lucrative weekend program? Is it because that would make finding weekend teachers more difficult, thereby reducing profits? Delgado may not be that mercenary, but the conflict and the line of reasoning that comes with it should be apparent.

Setting aside conflicts, the board also should have taken appearances into account. If Grey CAA ever finds itself subject to media scrutiny, this arrangement is likely to be become public knowledge. The board might be able to rationalize the conflict, but members of the media and other watchdogs will inevitably criticize this sort of arrangement. Might adverse publicity hurt fundraising efforts or public support?

C. Insurance, Rent and Computers

The board should be criticized for its apparent failure to focus on the details. Normally, those details should be left to the CAA's officers and employees, but the conflict in this case requires much more vigilant oversight. Somebody other than Delgado and those who report to her should have represented Grey CAA's interests in the negotiating and structuring of the arrangement. That means separate legal counsel representing the board or the board committee negotiating the arrangement.

If the business plan called for No Sweat to rely on Grey CAA for insurance or computer equipment, then Grey CAA should have either received credit for the value of those items when it re-

ceived its interest in the enterprise or there should have been an agreement providing for compensation. There also should have been a negotiated lease covering the use of Grey CAA's facilities. Once again, someone other than Delgado should have represented Grey CAA in the negotiations. It is not at all surprising that the state auditors questioned the arrangement. The basic question: Is the failure of No Sweat to reimburse Grey CAA for No Sweat's allocable share of these costs an innocent oversight, or does it represent intentional fraud.

D. Labor and Employment Law Issues

The Fair Labor Standards Act requires that employers pay the minimum wage and also pay overtime if an employee works more than 40 hours in a work week.

1. Paid Teachers and Volunteers

Grey CAA and No Sweat should both seek employment law counsel regarding FLSA compliance because it is not clear whether Grey CAA and No Sweat are treated as one employer or two separate employers for FLSA purposes. If Grey CAA and No Sweat are treated as one employer for FLSA purposes, there is a greater likelihood that the two entities will be required to pay overtime.

2. Volunteer Protection Act

The teachers ostensibly are volunteers in the afterschool program, which would entitle them to the shield from liability provided by the Volunteer Protection Act. If, however, the teachers can only work in the weekend program if they volunteer in the afterschool program, their service in the afterschool program may no longer be considered voluntary.

E. Right to Information

Grey CAA was the minority partner in the venture, but that should not preclude Grey CAA from receiving information. Those negotiating on behalf of Grey CAA should have included provisions in the agreement that assured Grey CAA was provided with adequate information, including the right to financial statements and reports describing major decisions and activities. A good case can be made that Grey CAA should have obtained the right to conduct audits. These are not theoretical rights. In one case involving social entrepreneurship, the nonprofit entity that held a minority position alleged that it was not receiving adequate information about the venture.

F. Tax Issues

1. Tax-Exempt Status

Before ever entering into an arrangement involving for-profit entities, a tax-exempt nonprofit should seek the advice of qualified tax counsel. To qualify as a Section 501(c)(3) organization, an entity must be able to demonstrate that its assets are being used for the benefit of its charitable beneficiaries rather than private interests. Anything more than incidental private benefit could result in loss of tax-exempt status. The No Sweat transaction is exactly the type of transaction that could result in loss of tax-exempt status if not property structured. Grey CAA should be able to demonstrate that:

a) The investment furthers its tax-exempt purpose or mission; and

b) It is in control of the day-to-day operations of the joint venture.

The terms of the joint venture provide that the joint venture cannot engage in activities that would jeopardize Grey CAA's tax-exempt status. There should be safe guards in place that assure that the operation of the joint venture in furtherance of Grey CAA's exempt purpose does not become subverted to the interests of the for-profit partners.

At this time, the law is not entirely clear what is and is not permissible. Any tax lawyer looking at this arrangement would recommend that certain changes be made in order to protect Grey CAA's exempt status. Specifically, the lawyer would want Grey CAA to be in control of No Sweat's curriculum and educational activities. This might require that Grey CAA have the right to alter No Sweat's curriculum to better suit the needs of low-income children. Although Delgado and Wilcox might be able to hold a greater than 50% economic interest in the venture, they should not have control over the operational aspects of the venture that further Grey CAA's mission. The parties might use a management contract to assure that Grey CAA has sufficient control. The parties should also be able to demonstrate through concrete evidence that No Sweat is reimbursing Grey CAA at fair market value for joint venture's allocable share of insurance premiums, the rental value of the facilities and the computers, and other direct and overhead expenses that are incurred by Grey CAA, but which benefit No Sweat to some degree.

2. Intermediate Sanctions

The intermediate sanctions are a set of tax rules that require that transactions between a tax-exempt section 501(c)(3) organization and an insider such as a board member, officer, or key employee with substantial influence be priced or valued so as to reflect fair market value. The rules are most often discussed in terms of setting compensation, but they also apply to other transactions, which include property transactions like an investment in a joint venture. Consequently, Grey CAA's decision to enter into the joint venture should be made by independent members of the board of directors and that decision should be documented contemporaneously. Moreover, Grey CAA should have an appraisal or other evidence that it received fair value for its investment.

3. Unrelated Business Income

Whenever a tax-exempt entity enters into a joint venture with an individual or for-profit entity, it must be concerned whether the income it receives from the arrangement constitutes unrelated business income, which is taxable at corporate income tax rates. A good case probably can be made that the No Sweat venture does not produce unrelated business income because the venture benefits low-income individuals on a subsidized basis, but someone must review the issue, particularly if the venture will incur debt.

G. Federal Procurement Law

Recipients of federal grants and CSBG grants generally must comply with the regulations (referred to as circulars) promulgated by the Office of Management and Budget. Circular A-122 sets forth cost principles applicable to nonprofit organizations seeking reimbursement under grants for expenditures. When a cost incurred by a nonprofit benefits both the program funded by the grant and another program, only the portion of the cost attributable to the funded program is eligible for reimbursement. Circular A-122 sets out the rules for making these allocations. These rules would limit the amount of otherwise eligible expenses that Grey CAA could fund through a federal or CSBG grant.

V. Background Material

For additional commentary, review Section III (Conflicts of Interest) of the Background Material accompanying the case studies.

Case 8: Setting the Executive Director's Compensation

I. Context

One of the board's primary functions is setting the executive director's compensation. That compensation must be reported on the agency's annual Form 990, which is filed with the IRS and available for public inspection at http://www.guidestar.org. Whenever a nonprofit runs into trouble, one of the first pieces of information the media examines is the executive director's compensation. State regulators and the IRS both are concerned with and have authority to address excessive compensation. Although setting compensation is the board's responsibility, the executive director also should want a defensible and objective process. Under the federal tax law, the IRS can force the executive director to return any excessive compensation to his employer, plus pay a 25% penalty to the IRS.

II. Facts

KCMC Child Development Corporation (KCMC) was located in Kansas City, Missouri. For its 2002 fiscal year, KCMC had an annual budget in excess of $26 million.[1] Its executive director had been with the agency for close to 25 years when a major controversy erupted over the level of his pay. [2]

A. Executive Director Compensation

According to media accounts, the executive director's compensation, as reported on Form W-2, was $237,000 in 2000, over $310,000 in 2001, and $247,000 in 2002.[3] The completeness of these numbers is open to question. The agency's Form 990 for 2001 reported the executive director had received $343,064 in compensation.[4] According to news accounts, the executive director received a signing bonus, as well as performance and Christmas bonuses. These bonuses presumably were included in the W-2 amounts. KCMC also leased a Mercedes SUV for the executive director's use and incurred expenses to fund his retirement. It is not clear whether these or any other fringe benefits were included in the W-2 amounts. In any event, the U.S. Department of Health and Human Services (HHS) informed KCMC that HHS had issues with the level of compensation paid to the executive director.[5]

B. Comparables

In responding to federal officials regarding the reasonableness of the executive director's compensation, KCMC suggested that its executive director may have actually been underpaid.[6] A public relations firm, in summarizing a letter provided to the federal government by KCMC, said that the executive director had "run a program that has set national standards and that has been

1 Deann Smith and Dan Margolies, *Head Start Fallout Spreads*, KANSAS CITY STAR, Oct. 23, 2003.

2 Dan Margolies and Deann Smith, *Kansas City, Mo. Head Start Executive's Salary is Defended*, KANSAS CITY STAR, Jan. 10, 2004.

3 *Head Start Fallout Spreads* , note 1, *supra*; and Deann Smith and Dan Margolies, *Head Start Fallout Spreads: Congress Notices KC Director's Salary*, KANSAS CITY STAR, Oct. 20, 2003.

4 *Head Start Executive's Salary Defended*, note 2, *supra*.

5 Associated Press, *Feds Investigating Head Start Chief's Pay*, MORNING SUN, Oct. 10, 2003.

6 *Head Start Executive's Salary Defended*, note 2, *supra*.

cited as a national model and that puts him at the higher percentile." The response also indicated that KCMC's board was concerned that some other organization would attempt to recruit its executive director. The executive director was the head of the National Association for the Education of Young Children, making him, in KCMC's words, "a nationally respected professional in early childhood education." According to newspaper reports:

1. The board did not rely on a compensation study when setting the executive director's compensation, but the board did use a study to respond to a federal agency's investigation.

2. The compensation study used to respond to the federal agency examined data from 18 "comparable" agencies, concluding that a fair salary would be $282,360. These agencies included: (i) a United Way; (ii) an art museum; (iii) an organization that operated a psychiatric hospital; and (iii) a YMCA. Top salaries paid by these organizations ranged from $146,000 per year to $226,000.

3. The director of a comparable organization ($18 million annual budget) located in the same state was paid $123,556 in 2001.

4. Public school superintendants in the same locale were paid significantly less than the executive director.[7]

C. An Agency With Problems

KCMC had significant problems in the years immediately preceding the controversy, raising serious questions as to whether the executive director was the stellar performer that his salary implied.

1. A June 30, 2004 audit raised questions as to whether the agency was a going concern because it had current liabilities in excess of its current assets and had recently experienced a significant decrease in its net assets.[8]

2. A federal review resulted in a determination that the agency owed the federal government at least $1.2 million.[9]

3. The agency appears to have significantly overspent its budget.

4. A former KCMC controller pled guilty in February 2002 to participation in a kickback scheme involving renovations to the agency's facilities.[10] The indictment alleged that the controller received over $200,000 in kickbacks.[11] The executive director characterized his relatively high pay level as a reward for responding to the discovery of the kickback scheme.[12]

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7 Laura Scott, *Keep Closer Eye On Head Start Programs; Curb Director's Excessive Pay*, KANSAS CITY STAR, Oct. 15, 2003.

8 Kansas City, Missouri, City Auditor's Office, REVIEW OF AUDITS OF OUTSIDE AGENCIES (March 2006).

9 Deann Smith and Dan Margolies, *Steeped in Debt, Head Start Provider in Kansas City, Mo. Says It Must Bow Out*, KANSAS CITY STAR, Dec. 11, 2004.

10 Dan Margolies, *Head Start Agency Looks to Revamp Board*, KANSAS CITY STAR, Dec. 26, 2003.

11 *Head Start Fallout Spreads*, note 1, *supra*.

12 Deann Smith, *Head Start's Local Agency Settles Case: Current Board Set to Resign*, KANSAS CITY STAR, Apr. 15, 2004.

D. Board Structure

In 2003, KCMC's board had 15 positions, including four vacancies.[13] In a letter sent to several nonprofit institutions in the community, KCMC indicated that the agency's board planned to amend the agency's bylaws to eliminate open-ended terms. Directors would be limited to two consecutive three-year terms.

E. Lawyer's Viewpoint

A lawyer associated with KCMC characterized the federal government's efforts to recoup some of the executive director's salary as the efforts of right-wing opponents to Head Start.[14]

III. Discussion Questions

The following questions are offered for discussion:

A. What criteria should be used by the board in setting an executive director's compensation?

B. When examining comparables, should the universe of nonprofits be limited to nonprofits:

1. Located in the same community?

2. Receiving grant money from the same sources?

3. Can for-profit entities be included?

C. How should the executive director's longevity factor into the analysis?

D. Should the agency set salary at a level designed to prevent another organization from luring the executive director with a more lucrative offer?

E. Should the executive director be held accountable if there is a major fraud on his watch?

13 *Head Start Agency Looks to Revamp Board*, note 18, *supra*.
14 Editorial, *Board Needs Reality Check*, KANSAS CITY BUSINESS JOURNAL, Jan. 30, 2004.

IV. One Suggested Solution

A. Basics

In setting the executive director's compensation, the board should rely on a clearly-defined deliberative process. The board should consider using a compensation committee to undertake the analytical work, with the final decision reserved to the full board. Those involved in the process should be independent of the executive director. The board should rely on comparables, as well as performance reviews.

B. Head Start Limitations

1. Policies

Under the Head Start Act, each Head Start agency must:

a) Establish specific standards governing salaries, salary increases, travel and per diem allowances, and other employee benefits.

b) Assure that only persons capable of discharging their duties with competence and integrity are employed and that employees are promoted or advanced under impartial procedures calculated to improve agency performance and effectiveness.

c) Guard against personal or financial conflicts of interest.

2. Salary Cap

No Federal funds may be used to pay any part of the compensation of an individual employed by a Head Start agency, if such compensation, including non-Federal funds, exceeds an amount equal to the rate payable for level II of the Executive Schedule under section 5313 of title 5 of the United States Code.

a) The Current Level

The Executive Schedule is periodically adjusted. The level II rate was last reset in January 2009 to $177,000.

b) Total Compensation

The salary cap applies to total compensation paid to an employee. That means that no Federal funds can be used to pay an employee's salary if the employee's total salary exceeds the cap. For example, if an executive director was paid $200,000 a year, with $190,000 of his salary funded by private sources, the other $10,000 in salary could not be funded with Head Start funds.

c) Compensation

The term compensation includes salary, bonuses, periodic payments, severance pay, the value of any vacation time, the value of a compensatory or paid leave benefit and the fair market value of any employee perquisite or benefit, but excludes any Head Start agency expenditure for health, medical, life insurance, disability, retirement, or any other employee welfare or pension benefits.

C. Intermediate Sanctions

The intermediate sanctions are a comprehensive set of tax rules designed to assure that compensation paid to key employees and other insiders reflects market-rate compensation. If the IRS determines that the compensation is excessive, it can force the recipient to return the excess to the exempt organization and assess an excise tax equal to 25% of the excess on the recipient. The centerpiece of this regime is a rebuttable presumption that compensation is reasonable if certain procedures are adhered to when setting the compensation. Specifically, the organization must demonstrate that (i) the compensation arrangement was approved in advance by the board of directors (or a committee thereof); (ii) such board (or committee) was comprised entirely of individuals who did not have conflicts of interest; (iii) such board (or committee) obtained in advance and relied on appropriate data as to comparability of the compensation arrangement; and (iv) such board (or committee) adequately documented the basis for its determination concurrently with the decision. The rules contemplate otherwise conflicted individuals recusing themselves from the process.

1. Consultants

Some boards seek the advice of an outside consultant when setting the executive director's compensation. This is appropriate, but the consultant must be independent. That means that the board should select the consultant. It also means that there should be no hidden conflicts. For example, the consultant should not be providing other consulting services to the CAA (e.g., advising on employee benefits) if the executive director controls the selection of the consultant.

2. Comparables

The executive director's compensation should take comparables into account. Selecting comparables can be tricky. KCMC chose to include the compensation paid to the executive director of an art museum, a YMCA, and a United Way in its survey of comparables.

3. Proper Focus

a) Focus on the Organization

Some will argue that a CAA cannot use the amount of compensation paid to an executive director of a local United Way or art museum as comparables because a CAA is an operating social services agency, while a museum is engaged in an entirely different activities and a United Way is largely a grantmaking organization. Those who make this argument believe that the comparables should be limited to organizations engaged in similar activities. In their view, the decision to look to another sector for compensation comparables may be a sign that the organization is selecting organizations to justify a predetermined level of compensation. According to advocates for this viewpoint, relying on comparables from organizations engaged in different activities is particularly troublesome if the organizations selected draw on a entirely different labor pool.

b) Focus on Skills

Others argue that the focus when selecting comparables should be on positions that require similar skills regardless of whether the organizations are engaged in similar activities. Under this view, the skills required of a good executive director or CFO are the same regardless of whether the organization is an art museum, United Way, YMCA, or zoo. An executive director, for example, must be able to work with a board, supervise and guide program heads, and listen to those who rely on the organization's services. A CFO must be able to establish in-

ternal controls, manage a staff of accountants, communicate with the executive director and board about financial matters, and work with auditors. People who hold these higher level positions require many of the same skills regardless of the organization's mission or specific activities. Advocates for this position might point to Bob Nardeli, who has headed up both Chrysler and Home Depot. He also was held a top-level executive post at General Electric. Those companies are engaged in entirely different activities, yet Nardeli's executive talents were readily transferable.

4. Examples

a) Looking to a YMCA for Comparables

Like CAAs, some YMCAs provide a wide range of social services to people within a community. Some YMCAs operate programs for the elderly, day care centers, and after-school programs for at-risk youth. These YMCAs may rely heavily on the government grants for funding. Under these circumstances, a CAA might appropriately look to the amount paid to the executive director of a local YMCA as a comparable. On the other hand, some YMCA's function as athletic clubs, relying heavily on membership dues for their revenue. In these cases, a CAA may have more difficulty treating the compensation paid to the executive director of the local YMCA as a comparable. The executive director may have specialized skills required to run an athletic club that place him in a different labor market.

b) Looking to an Art Museum for Comparables

A CAA might look to a local art museum for comparables. This might be appropriate when setting the salary of a CFO or the head of HR. The skills possessed by these individuals are easily transferable to organizations in different sectors.

A CAA should be more reticent when it comes to relying on the compensation paid to the executive director of an art museum as a useful comparable. While a CAA executive director requires many of the same management skills as the head of an art museum, there may be significant differences between the two. First, and foremost, the museum may require someone with advanced education in the arts or art history. That may limit the museum to a specialized labor market. Both the executive director of a museum and a CAA require fundraising skills. Fundraising in the arts relies heavily on entertaining and personal relationships, but fundraising for CAAs requires grant writing and administration skills. These differences undercut reliance by a CAA on compensation data sourced to a museum or other cultural institution.

5. Looking to other CAAs

Those assembling the data must be careful even when selecting CAAs for comparison. A CAA located in an urban area probably is not comparable to one located in a rural community. Moreover, an agency with one or two programs probably should not view agencies with ten or twelve programs as comparable.

6. Conclusion with Respect to Comparables

There is no one rule that can be used to determine whether a CAA can characterize positions with other organizations as comparable ones. The board must consider all the facts, examining organizational context, the labor market, and the position being evaluated and its duties. In the end, the old adage "To thine own self be true" applies. If a board makes a good faith effort

to examine comparables that truly are comparable, it should have a supportable position. If the board simply is supporting a predetermined decision with nothing more than dollar amounts, it should not be surprised if the IRS, a state regulator, or a government funder reject the data.

D. Lake Wobegon Syndrome

According to Garrison Keillor, in Lake Wobegon, "the women are strong, the men are good looking, and all the children are above average." That adage doesn't apply just to those living in Lake Wobegon. Many boards and compensation committees routinely peg an executive's compensation at the 70% percentile when examining a series of comparables. Boards should recognize that there are legitimate reasons for pegging an executive director at the 30% or 40% levels. For example, a new hire may be a perfect fit on paper, but may lack any relevant experience.

E. Bonuses

Any bonus should be paid for demonstrable performance. It should be tied to pre-defined benchmarks. A bonus should never be paid simply because there is extra money in the budget.

F. Tally Sheets

Each board member should be provided with a tally sheet before being asked to approve the executive director's compensation package. A tally sheet is a one- or two-page summary of the executive director's compensation, listing the base amount of pay (cash), fringe benefits, perquisites, company-financed contributions to qualified plans, deferred compensation, and expense reimbursement plan. It provides an overall sense of the executive director's total compensation.

V. Background Material

For additional commentary, review Section I (Setting Compensation) and Section II (Incentive Compensation) of the Background Material accompanying the case studies.

Case 9: Using Comparables to Set the Executive Director's Compensation

I. Context

One of the board's critical functions is setting the executive director's compensation. That compensation must be reported on the agency's annual Form 990, which is filed with the IRS and available for free download courtesy of GuideStar at http://www.guidestar.org. Whenever a nonprofit runs into trouble, one of the first pieces of information the media examines is the executive director's compensation. State regulators and the IRS are both concerned with and have authority to address excessive compensation. Although setting compensation has clear repercussions for the board, the executive director also should want a defendable and objective process. Under the federal tax law, the IRS can force the executive director to return any excessive compensation to his employer, plus pay a 25% penalty to the IRS.

This case study examines how the board of a CAA might use data taken from the annual Forms 990 filed by other CAAs. The CAA and the board members in this case study are fictitious, but the salary data for the other CAAs was taken from the tax returns for existing agencies all located in the same state.

A. Other Options

Examining Form 990 data is just one available option for developing comparables. CAAs also can utilize the Economic Research Institute's Nonprofit Comparables Assessor, which is based on Form 990 data. For more information about this subscription service, go to http://www.erieri.com. GuideStar is a nonprofit corporation that maintains a database of Form 990s. They also have fee-based services for mining their databases for compensation comparables. For more information, go to http://www.guidestar.com. CAA's also can retain a compensation consultant such as Mercer Consulting or Hewitt Associates, or work with an accounting firm that has experience in developing compensation comparables.

B. Cautionary Note

While this case study uses actual Form 990 data, the sampled data should not be relied on by any agency. Each agency must examine each sampled organization to determine whether comparisons are appropriate. Moreover, the facts about each agency in the sample have been made up. This case study illustrates how a CAA might use Form 990 to assess whether the salary paid to its executive director or other highly compensated employees is reasonable.

C. Form 990 Limitations

The Form 990 has recently undergone a massive overhaul. The revised form first will be used for 2008 tax years. In the past, disclosures about positions other than the executive director had been hit or miss. Consequently, users often found it difficult to find information about each highly-compensated employee. Compounding the problem, position descriptions do not always reflect what functions are performed by the person holding the position. That said, Form 990 data often is the only relevant information that is readily available. The quality of this information should improve as organizations begin to use the redesigned Form 990 in 2008.

In reviewing Form 990 data, it is preferable to focus on agencies that the analyst knows something about — often those in the same state.

II. Facts

Madison Community Action Agency (MCAA) is a recipient of CSBG funds, as well as other federal and state grants. It has been in existence for 30 years. MCAA sponsors Head Start, Weatherization, credit-counseling, adult literacy, fatherhood skills, and family outreach programs.

A. The Executive Director

Gloria Watson has been MCAA's executive director since January 1996. She holds a masters degree in public administration from Arcade College. She is a savvy operator, having expanded MCAA's annual budget from $650,000 to $9 million. Watson earned $65,000 last year. She recently received an offer from a large bank to head its community reinvestment program. She is tempted, given the fact that the salary and benefits for the new position would be $135,000.

The board has been extremely pleased with Watson and does not want to lose her. It has asked its compensation committee to develop a pay package that would cause Watson to reject the bank's offer.

B. The Compensation Committee

The compensation committee is comprised of the following board members:

Larry Gilroy — Mayor's Office for Community Development

Melanie Rigga — Well-known community activist

Melba Jones, Attorney — general practitioner (handles minor personal injury cases, residential real estate closings, and simple divorces)

Freda Feldman — Parent of a Head Start student. Works at a local dry cleaners

Chairman of the Board Victor Gasque — Local office staff member for Congresswoman Betsy Rago

Harvey Mellon — Vice-president of Community Affairs, Carbonside Electric Power.

C. The Meeting

Victor Gasque: As you know, we have a limited amount of time to come up with a competing offer if we are going to keep Gloria on board. Of course, I am assuming that we want to keep her, but given the remarkable job she has done for us, I don't know why we wouldn't. Has everyone had a chance to review the data that we assembled?

Freda Feldman: I agree. Gloria is top notch. She has really brought in some terrific Head Start teachers and she knows how to motivate them. But I have to say, we have limited resources. I just

can't see nearly tripling her salary. I seem to live pretty well on $38,000 a year.

Harvey Mellon: Freda, I am concerned about your reference to your own salary. MCAA may be a nonprofit, but we have to compete with for-profits for leaders and administrators. In my estimation, there is too much emphasis placed on keeping administrative costs down so that funds are used to serve our clients. I am all for keeping these costs low, but at the end of the day a good administrator furthers mission.

Freda Feldman: I understand that we may have to pay Gloria more, but I think anything more than $80,000 can't be justified. There are other people who can do Gloria's job for a lot less.

Melba Jones: I tend to agree with Freda. We should take great satisfaction in knowing that our organization was instrumental in developing Gloria's skills, but we have to be realistic. As people become more skilled, other opportunities present themselves and we just are not going to be able to match the compensation that comes with those opportunities.

Victor Gasque: OK, I think we are putting the cart before the horse. We are all in agreement that we would like to keep Gloria if possible and we recognize that we are going to have to pay more money to do that. I asked Larry to assemble some information about other CAAs in the state so we can see if we are even in the ballpark.

Freda Feldman: Before the meeting, I reviewed the data that Larry included in the board packet. I have some trouble with your basic premise of relying on this data.

Victor Gasque: How so?

Freda Feldman: Well, for starters, we are in a state that has agencies evenly split between urban and rural communities. We are in an urban area. Is it even appropriate to be looking at statistics for agencies located in rural areas? I also note that some of the agencies don't have anywhere near the number of programs that MCAA has.

Victor Gasque: Those are legitimate points, but I think we easily can weed out the rural agencies if you think that is appropriate. We know most of the agencies on Larry's list. As for agencies with fewer programs than us, I would think, all other things being equal, that the salaries of their executive directors should be lower—so they provide a floor. Larry, please take a few minutes to summarize your findings.

Larry Gilroy: As you can see, I obtained data for 23 agencies. When I constructed a scatter diagram to examine the correlation between the executive director's compensation and the agency's total support, I found a fairly positive correlation. I also looked at the correlation between an agency's net assets and its executive director's compensation. I did not find a meaningful relationship.

As you know, MCAA receives about $9 million in annual support. As for the urban/rural distinction, we should keep that in mind, but the vast majority of agencies that receive support in excess of $5 million are located in urban areas.

The executive director of the Williams Agency topped the compensation list, earning $161,543

annually. Yes, that agency had $23.1 million in total support, but the executive director's salary still makes her an outlier. The next highest salary was paid by Borsman Community Action—its executive director received $141,978. Borsman receives $21.755 million in public support.

Obviously those agencies pay compensation that is competitive with the bank's offer to Gloria, but both agencies are twice the size of Madison in terms of total support.

Now take a look at the Jackson Action Agency. It tops the list in total support, at close to $28.5 million, but its executive director is paid just $110,000 per year. Larken and Kirkland also have significant levels of support, but their executive directors earn $99,000 and $117,000 per year, respectively. Based on those numbers, one could argue that the executive directors at the Williams and Borsman agencies are overpaid, although there may be justifying factors for the higher compensation.

The agency that comes closest to MCAA is Flattenbrook Action. It receives about $10 million in support. The executive director is paid somewhere around $62,000 per year.

Melanie Rigga: Larry, I will let you continue, but I know about Flattenbrook Action. Their executive director is relatively new. I knew the prior executive director. She'd been there about 20 years and was making somewhere around $90,000 a year.

Freda Feldman: Larry if I could interject. Take a look at Newburg Community Action. Their ED makes $36,731. They have $10 million in support. How can we justify paying Gloria anywhere close to $135,000 a year given that fact.

Larry Gilroy: I am glad everyone is taking a close look at the data. Freda, I am not so sure that the ED at Newburg Community Action is actually the person in charge. They have a CFO who is making over $95,000 a year.

In any event, let me summarize the data as I see it. In all honesty, I don't think we can justify matching the $135,000 offer. We've been looking at comparables and I suspect that we could justify $75,000 or $85,000—and that is a push.

I should note that Neville Social Services pays its executive director about $70,000 a year and it only receives $7.9 million in total annual support. I called the executive director at Neville to get a sense of what sort of services they provide. It turns out that their programs are quite similar to ours. Additionally, they have the same number of employees as we do. Those facts would support raising Gloria's salary to somewhere over $70,000 per year. But at the end of the day, I just don't think we can go much above $75,000 or $80,000 per year.

I should also note that we have to look beyond just the comparables. Let's not forget our budget. We were hard-pressed this past year to arrive at a balanced budget. And as you all know, there is a good chance that some of our funding may be cut next year. Our state AXA program[1] grant will likely be eliminated given the impasse between the governor and the legislature. In any event, I don't think any of us want to cut the services being funded with those dollars.

Harvey Mellon: Larry you bring up a good point about the budget. I am a firm believer in keep-

1 This is a fictitious grant program.

ing it in balance. I know that the board is not going to cut the AXA program services. As much as it pains me, I think we are going to lose Gloria. We can't go over $75,000. There is no way that we are going to keep her.

Victor Gasque: What I am hearing from everyone is that we should inform the board that we simply can't match the offer, or even come close. The level of compensation that MCAA would have to pay Gloria to be competitive with the bank's offer can't be justified given the size of our agency.

Larry, this has been very helpful. I suspect that the committee will meet again to discuss the compensation package that we will be offering to what is likely to be our new executive director. Whatever you do, don't throw the data you have gathered out. In fact, if you could refine the data, I think the committee would be very appreciative. See if you can isolate the urban agencies. Also, see if you can find out the tenure for each executive director.

III. Discussion Questions

The following questions are offered for discussion:

A. Should a compensation committee or the board look to Form 990 compensation data for comparable organizations when setting the executive director's compensation?

B. Are there other sources for obtaining comparables for purposes of setting the executive director's compensation?

C. In examining compensation data for other organizations for purposes of setting the executive director's compensation, what factors should the compensation committee or board use to assess whether other organizations are comparable to the agency?

1. Urban/ rural?

2. Asset size?

3. Gross revenue?

4. Number of programs?

5. Number of agency employees?

6. Executive director's fundraising responsibilities?

7. Executive director's tenure?

8. Executive director's experience?

9. Alternative employment opportunities?

10. The agency's prior history (e.g., in serious trouble with regulators, which has resulted in the

decision to hire a new executive director)?

11. Executive director's performance, as reflected in agency growth and tangible achievements related to mission?

D. Should MCAA even try to match the bank's $135,000 offer?

E. Should people who work for nonprofits be expected to accept a lower salary than their for-profit counterparts? Is there a different answer if the person in question is an administrative assistant or a bookkeeper rather than the agency's executive director or CFO?

F. How has your agency dealt with the problem of competing offers or opportunities that carry significantly higher compensation?

G. Should Larry Gilroy have called the executive director at Neville Social Services?

IV. One Suggested Solution

A. Overview

As should be apparent, the compensation data from the Form 990 is only as good as the thought and judgment that goes into analyzing it. As a practical matter, the board (or compensation committee) should probably begin by obtaining Form 990 data for CAAs in the same state. Presumably the board or employees of the CAA know something about other CAAs in the same state. That knowledge will prove helpful.

B. One Starting Point

1. Relevant Form 990 Data

For tax years beginning in 2008, each CAA will report compensation for each director, officer, key employee, and highest-paid employee in Part VII of the Core Form 990. A highest-paid employee is one who receives reportable compensation that exceeds $100,000, but only if the individual is one of the top five highest paid employees. If anyone required to be listed in Part VII receives over $150,000 in reportable compensation, then Schedule J must be completed (Part I for all insiders and Part II for just the individuals who exceed the $150,000 threshold). Each agency will report its net assets on Line 22 of Part I of the Core Form 990.

2. Sorting the Data Points

The compensation/net assets for each agency should then be sorted in ascending order based on compensation. This is the approach that is reflected in the schedule accompanying this case study. The agency's own net assets should then be compared to the data in the schedule. This will provide a base or starting point for the analysis. There are lots of reasons why the executive director's total compensation might or should be significantly higher or lower than the base point.

a) Program Complexity

The analyst should consider the number of programs run by each agency. The analyst will want to look at Part I, Line 1 and Part II of the Core Form 990 to assess the types and size of major programs, together with any Web site maintained by the CAAs. Line J of the Signature Block on the first page of the Core Form lists the organization's Web site. In many cases, the analyst will be familiar with the CAAs and their programs. All other things being equal, an executive director for a CAA with two programs should probably make less than an executive director who heads a CAA with 15 programs. That is particularly true if the agency with 15 programs has significantly more grant revenue, employees, and/or clients.

b) Urban/Rural Distinction

The analyst should distinguish between entities that operate in rural and urban areas. If the agency in question operates in an urban environment, that could mean simply disregarding all the data from those agencies in rural areas. The better approach would be to ascertain whether there is a relatively fixed differential between the compensation paid by urban and rural agencies.

c) Executive Director's Experience

The Form 990 is unlikely to provide any information regarding executive director job longevity, experience, or educational background. This is meaningful information, so the analyst

might have to survey people within her own agency to ascertain levels of executive director experience and training for other agencies.

d) Alternative Employment Opportunities
Somebody should be keeping track of job offers that the agency's executive director has received. This information will likely be available on an ad hoc basis. Some executive directors will not say anything about offers they receive. Others may make offers known for the very purpose of influencing compensation.

e) Performance
If the executive director was hired to fix an agency with serious problems and she has been highly successful, that information should be taken into account. On the other hand, if an executive director is paid a certain amount and it is known that his agency is looking for a new executive director, the analyst might conclude that his salary should be discounted from comparable salaries.

C. Report

All the data should be assembled and analyzed in a written report to be provided to the board or its compensation committee. As should be apparent, this is a subjective process. At the end of the day, the report should provide a defensible analysis of why a particular level of compensation for the executive director is appropriate. The report should be more systematic than the discussion that took place in the MCAA board meeting, but it should reflect the issues and concerns discussed during that meeting.

D. Other Alternatives

If properly collected and analyzed, the data taken from Forms 990 for other CAAs could provide useful comparables for setting executive director compensation. Boards, however, are not limited to using Form 990 data. In fact, if a board is unable to obtain sufficient information regarding subjective factors, it should approach raw compensation information taken from Form 990s with skepticism. A board may prefer to hire an outside compensation consultant, review data from one of several services that compile compensation data, or obtain comparables for private sector positions with similar duties and responsibilities. In all likelihood a combination of these approaches is advisable even when the Form 990 data proves to be relevant. In sum, the Form 990 data is only a starting point.

E. Why Comparables Are Important — The Intermediate Sanctions

The intermediate sanctions are a comprehensive set of tax rules designed to assure that compensation paid to key employees and other insiders reflects market-rate compensation. If the IRS determines that the compensation is excessive, it can force the recipient to return the excess to the exempt organization and assess an excise tax equal to 25% of the excess on the recipient. The centerpiece of this regime is a rebuttable presumption that compensation is reasonable if certain procedures are adhered to when setting the compensation. Specifically, the organization must demonstrate that (i) the compensation arrangement was approved in advance by the board of directors (or a committee thereof); (ii) such board (or committee) was comprised entirely of individuals who did not have conflicts of interest; (iii) such board (or committee) obtained in advance and relied on appropriate data as to comparability of the compensation arrangement; and (iv) such board (or committee) adequately documented the basis for its determination concurrently

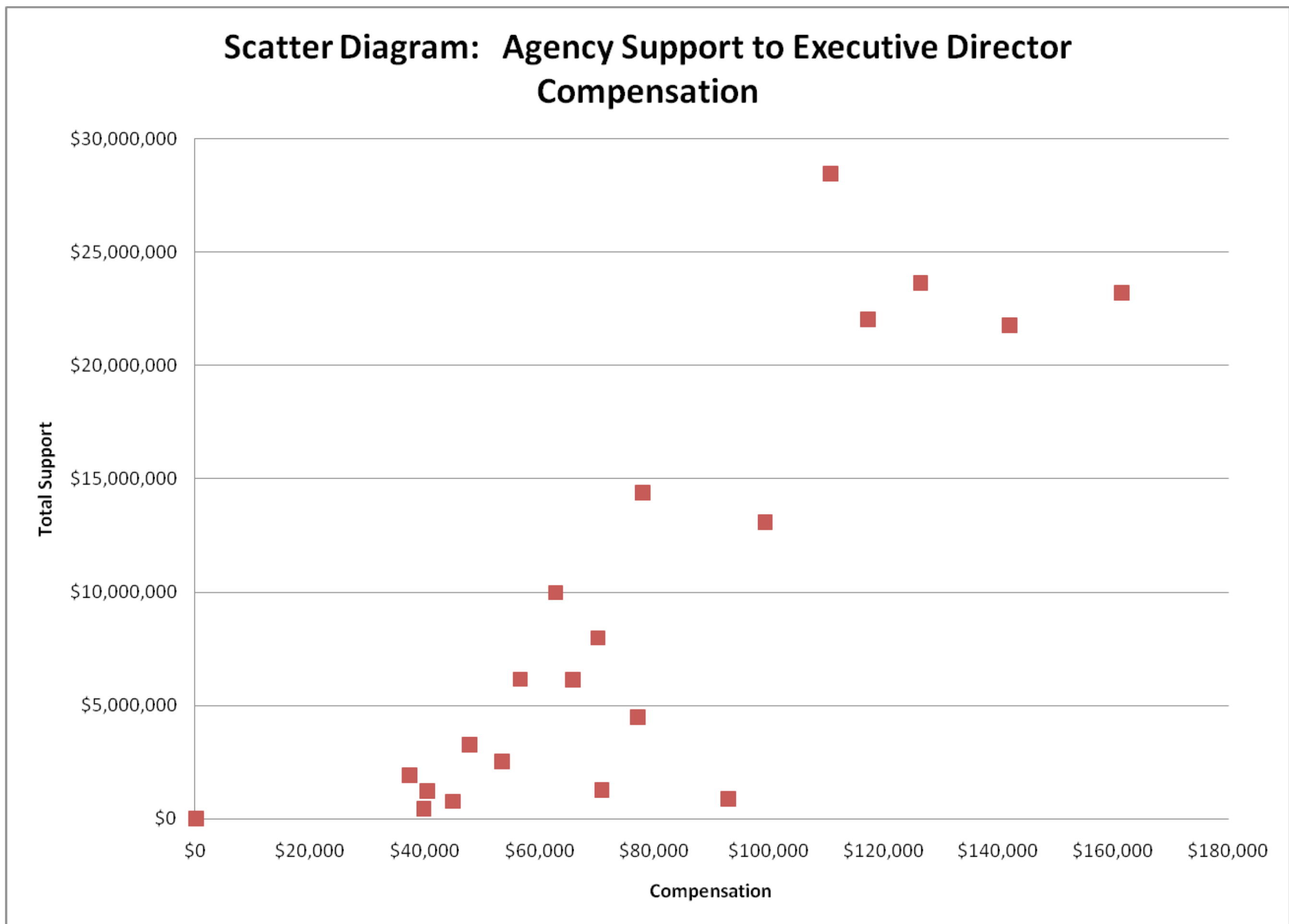
with the decision. The rules contemplate otherwise conflicted individuals recusing themselves from the process.

As you can see, compensation comparables play a central role in assuring that the rebuttable presumption is available. This is why developing a solid and defendable set of comparables is so important. It is also important because under federal and CSBG grant requirements, compensation must also be reasonable. Consequently, the use of compensation comparables also is important to support reimbursement requests.

V. Background Material

For additional commentary, review Section I (Setting Compensation) and Section II (Incentive Compensation) of the Background Material accompanying the case studies.

Agency Name	Executive Director Salary	Total Support
Agency 1	$29,049	$543,198
Newburg Community Action	$36,731	$10,089,830
Agency 2	$37,469	$1,915,859
Agency 3	$39,900	$454,914
Agency 4	$40,516	$1,223,372
Agency 5	$45,000	$776,740
Agency 6	$47,905	$3,251,249
Agency 7	$53,503	$2,533,594
Agency 8	$56,695	$6,142,480
Flattenbrook Agency	$62,883	$9,977,476
Litscomb CAA	$65,832	$6,124,899
Neville Social Services	$70,255	$7,977,990
Big Community Services	$70,953	$1,261,389
Cannon Community Assistance	$77,217	$4,474,914
Tonks Action Agency	$77,998	$14,373,215
Lucas Community Action	$92,927	$874,498
Kirkland Community Services	$99,347	$13,084,644
Jackson Action Agency	$110,776	$28,443,337
Larken Community Action	$117,262	$22,002,319
Hedwig Agency	$126,431	$23,613,264
Borsman Agency	$141,978	$21,755,663
Williams Agency	$161,543	$23,193,741


Scatter Diagram: Agency Support to Executive Director Compensation
Total Support
$30,000,000
$25,000,000
$20,000,000
$15,000,000
$10,000,000
$5,000,000
$0
$0
$20,000
$40,000
$60,000
$80,000
$100,000
$120,000
$140,000
$160,000
$180,000
Compensation