BOARDSOURCE®

101 BOARD BASICS

NONPROFIT ESSENTIALS – FAQs

How big is the U.S. nonprofit sector?

The American nonprofit sector grows steadily each year — except recently the IRS canceled the tax-exempt status for a large number of organizations that had failed to file their Form 990 during the past three years. The IRS data for 2011 indicates that there are close to 1.7 million nonprofits classified as 501(c) organizations. More than a million of them are 501(c)(3) public charities or private foundations. The figures do not include all churches that do not have to file with the IRS. Also, we can assume that there is a great number of active small nonprofits which, mainly due to the size of their programs, are not officially required to file for their tax-exempt status nor process their Form 990. See the page 56 in the www.irs.gov/pub/irs-soi/11databk.pdf .

Why do nonprofits have boards, and what do boards do?

Most nonprofits are corporations, which means they are legal entities distinct from the individuals who founded them. Like their for-profit counterparts, nonprofit corporations are governed by boards of directors with legal and ethical responsibilities that cannot be delegated. The board's responsibilities fall into the following broad categories:

Legal and fiduciary. The board is responsible for ensuring that the organization meets legal requirements and that it is operating in accordance with its mission and for the purpose for which it was granted tax-exemption. Individual board members must exercise the duty of care (meaning they must attend meetings, be prepared to make informed decisions by reading the information provided and requesting additional information if necessary, and carry out their duties in a reasonable and responsible manner). As safeguards of a public trust, board members are responsible for protecting the organization's assets.

Oversight. The board is responsible for ensuring that the organization is well run. It moderates the power of management, and has the power to hire and remove the chief executive, usually called the executive director or president.

Financial Resources. As part of their fiduciary responsibility, many board members are actively involved in making sure that the organization has the money it needs. This may include making a personal contribution; serving as an advocate with a foundation, corporation, or government entity; organizing a fundraising event or hosting a benefit; or face-to-face solicitation of other individuals.

Representation of constituencies and viewpoints. Often, board members are chosen so that they can bring to the board the experience or perspective of a particular group or segment of the organization's constituency. Boards are not inherently democratic institutions, but they do provide an opportunity for the groups and communities that a nonprofit serves to have a voice in its governance. However, representing a constituency or viewpoint takes a back seat when voting — all board members are expected to vote with the nonprofit's best interest in mind.

What is the difference between a governing board and an advisory board?

By law, every nonprofit must have a governing board. As the name indicates, the role of the board is to govern the organization and serve as its accountable body. The board helps create the vision, mission, values, and policies for the organization and makes sure that they are properly respected. Also, financial oversight is one of the key responsibilities of a nonprofit board.

An advisory council (or committee) usually functions like any committee of the board. It may be created for a specific purpose to assist the board in its work. For instance, advisory councils may focus on fundraising, provide technical assistance, assess the impact of a service or program, and serve as an advocate or a public relations representative for the organization. Advisory council members have no legal responsibilities; they have no vested right to serve; and they have no immunity from removal. It is wise to limit the council's actions to making recommendations and providing background for board decisions.

How are nonprofits monitored, regulated, and governed?

Nonprofits are not immune from damage that can be caused by unscrupulous and fraudulent solicitors, financial improprieties, and executives and board members who care more about their own financial welfare than the mission of the organization. Problems, when they do arise, are

particularly disturbing because of the nature of nonprofits themselves — organizations created to provide some public benefit.

Most people are familiar with the mechanisms that safeguard the integrity of government and business. Disenchanted voters can throw politicians out of office, and the branches of government view each other with watchful eyes. Businesses have shareholders or owners and are monitored by government agencies such as the Securities and Exchange Commission and the Occupational Safety and Health Administration. The media monitor both sectors, and are quick to point out cases of corruption, and poor performance.

Far fewer people understand how nonprofits are monitored and regulated. For much of its history, the nonprofit sector has operated outside the realm of harsh public scrutiny. No government agency exists exclusively to monitor the activities of nonprofits; most nonprofits aren't required to hold public meetings; and few journalists report on nonprofits with the same depth and focus devoted to business and government.

Nevertheless, nonprofits have many lines of defense against fraud and corruption:

Boards. All nonprofits are governed by a board of directors or trustees (there's no real difference), a group of volunteers that is legally responsible for making sure the organization remains true to its mission, safeguards its assets, and operates in the public interest. The board is the first line of defense against fraud and abuse.

Private watchdog groups. Several private groups (who are themselves nonprofits) monitor the behavior and performance of other nonprofits. Some see their mission as serving as advisors to donors who want to ensure that their gifts are being used effectively; others are industry or "trade" groups that provide information to the public and encourage compliance with generally accepted standards and practices.

State charity regulators. The attorney general's office or some other part of the state government maintains a list of registered nonprofits and investigates complaints of fraud and abuse. Often the state attorney general serves as the primary investigator in cases of nonprofit fraud or abuse. Almost all states have laws regulating charitable fund-raising.

Internal Revenue Service. A small division of the IRS (the exempt organizations division) is charged with ensuring that nonprofits are complying with the requirements for eligibility for tax-exempt status. IRS auditors investigate the financial affairs of thousands of nonprofits each year. As a result, a handful have their tax-exempt status revoked; others pay fines and taxes. In 1996, legislation authorized the IRS to penalize individuals who abuse positions of influence within public charities and social welfare organizations. Formerly the only weapon available to the IRS was to revoke tax-exemption, which resulted in the denial of service to the clients and constituents the organization was created to help. Because they fall short of revocation of tax-exempt status, these provisions are called intermediate sanctions.

Donors and members. One of the most powerful safeguards of nonprofit integrity are individual donors and members. By giving or withholding their financial support, donors and members can cause nonprofits to reappraise their operations.

Media. Most of the major scandals involving nonprofit organizations in recent years have come about as a result of media investigations and resulting news stories. While many nonprofit leaders feel misunderstood or even maligned by negative media coverage, this media watchdog role has resulted in increased awareness and accountability throughout the sector.

Can nonprofits make a profit?

Yes. Nonprofits can engage in revenue-generating activities that result in annual surpluses or profits. The distinction between nonprofits and for-profit companies is what happens to the surplus. For-profit businesses may distribute their gains to the owners or shareholders. Nonprofits must reinvest surpluses back into the organization and its tax-exempt purpose. Excess revenues may not be distributed to individuals affiliated with the organization.

Can a nonprofit organization have too much profit?

Being financially successful is the dream of just about every nonprofit. An operational surplus allows you to do even more with less stress and equips your organization to

undertake new activities to accomplish your mission. But you need to understand what is generating your surplus. If your organization engages in activities outside of its mission, you may be generating unrelated business income. Excessive unrelated business income may create UBIT (unrelated business income tax) or endanger the tax-exempt status of your organization.

A second important issue related to revenue is what you do with it. All surplus has to be invested back in the organization; it cannot go in the pockets of staff or board members. This rule applies whether your nonprofit has revenues of $4,000 or $40,000,000.

If your organization creates unexpected surplus, which cannot be used in operating expenses, you may wish to create an endowment, increase your rainy day reserves, or provide services at a lower cost to customers.

How does a nonprofit safeguard against organizational conflict of interest?

When the personal or professional concerns of a board member or a staff member affect his or her ability to put the welfare of the organization before personal benefit, conflict of interest exists. Nonprofit board members are likely to be affiliated with many organizations in their communities, both on a professional and a personal basis, so it is not unusual for actual or potential conflict of interest to arise.

Why must we be concerned about conflict of interest? Board service in the nonprofit sector carries with it important ethical obligations. Nonprofits serve the broad public good, and when board members fail to exercise reasonable care in their oversight of the organization they are not living up to their public trust. In addition, board members have a legal responsibility to assure the prudent management of an organization's resources. In fact, they may be held liable for the organization's actions. A 1974 court decision known as the "Sibley Hospital case" set a precedent by confirming that board members can be held legally liable for conflict of interest because it constitutes a breach of their fiduciary responsibility.

Does conflict of interest involve only financial accountability? No. Conflict of interest relates broadly to ethical behavior, which includes not just legal issues but considerations in every aspect of governance. A statement by Independent Sector describes three levels of ethical behavior: obeying the law; decisions where the right action is clear, but one is tempted to take a different course; and decisions that require a choice among competing options.

The third level of behavior can pose especially difficult ethical dilemmas for nonprofit board members.

What can we do to prevent conflict-of-interest situations? Self monitoring is the best preventative measure. Institute a system of checks and balances to circumvent actual or potential conflict of interest, beginning with well defined operating policies on all matters that might lead to conflict. Most important, create a carefully written conflict-of-interest policy based on the needs and circumstances of the organization. Ask each board and staff member to agree in writing to uphold the policy. A conflict of interest policy should be reviewed regularly as part of board self assessment.

What should be included in a conflict-of-interest policy? A policy on conflict of interest has three essential elements:

1. **Full Disclosure.** Board members and staff members in decision-making roles should make known their connections with groups doing business with the organization. This information should be provided annually.

2. **Board Member Abstention From Discussion and Voting.** Board members who have an actual or potential conflict of interest should not participate in discussions or vote on matters affecting transactions between the organization and the other group.

3. **Staff Member Abstention From Decision-Making.** Staff members who have an actual or potential conflict should not be substantively involved in decision-making affecting such transactions.

For a sample conflict of interest policy and disclosure form, see the BoardSource book, *Managing Conflicts of Interest*.

What are some examples of actual and potential conflict of interest? Organization policy requires competitive bidding on purchases of more than $1,000, but a printing firm owned by a board member's spouse receives the $25,000 contract for the annual report and no other bids are solicited.

A board member serves on two boards in the community and finds himself in the position of approaching the same donors on behalf of both organizations.

A staff member receives an honorarium for conducting a workshop for another group in the organization's field of interest.

Should an organization contract with a board member for professional services, such as legal counsel or accounting? Attorneys, accountants, and other professionals can contribute valuable expertise to a board. Due to the potential for conflict of interest, their contributions should be voluntary. At the very least, a board member who is associated with a firm competing for a contract should abstain from discussion and voting in the selection process. If a competitive bidding process results in the selection of that board member's firm, he or she should disclose the affiliation and abstain from voting on future board actions connected with that firm's contract with the organization.

How can I find what kind of nonprofits exist in my area?

A terrific Web-based clearinghouse, GuideStar www.guidestar.org helps people find information on specific nonprofits. GuideStar contains basic demographic data as well posts Form 990s for most filing nonprofits in the United States.

Does my state have an organization that provides services for nonprofits?

The National Council of Nonprofits, the nation's largest nonprofit network, works through its member state associations to amplify the voices of America's local community-based nonprofit organizations, help them engage in critical policy issues affecting the sector, manage and lead more effectively, collaborate and exchange solutions, and achieve greater impact in their communities. Search your state association here www.councilofnonprofits.org/find-your-sa

Are there organizations in Canada that help Canadian nonprofits?

Here are a few sites that are very helpful in providing information and assistance to Canadian nonprofits:

CharityVillage
https://charityvillage.com
Canada Revenue Agency
http://www.cra-arc.gc.ca/menu-eng.html
Imagine Canada
https://www.imaginecanada.ca/
Institute on Governance
http://iog.ca/

References

Advisory Councils
Board Fundamentals: Understanding Roles in Nonprofit Governance
Managing Conflicts of Interest: The Board's Guide to Unbiased Decision Making

All are available at www.boardsource.org or by calling 202-349-2500.