Nonprofits by the Numbers

In the wake of embarrassing revelations, high-profile scandals, and Sarbanes-Oxley, nonprofit CFOs are striving for greater transparency and accountability.

Bill Birchard, CFO Magazine
July 01, 2005

The whole affair shocked Stephen Howell, CFO of The Nature Conservancy, the largest philanthropic environmental group in the world. In May 2003, a three-part series in the *Washington Post* put the Conservancy's operations under a spotlight. While the newspaper didn't much dispute the charity's GAAP financial statements or IRS Form 990, it did question other numbers and business practices.

The *Post* noted, for example, that the disclosure of president and CEO Steven J. McCormick's 2001 compensation had not broken out lucrative components: a signing bonus of $75,000, a living allowance of $75,000, and a home loan for $1.55 million. Other revelations outraged members, such as the Conservancy's cozy relations with business interests and willingness to accept limited building on conservation land. True, the newspaper didn't flatly accuse anyone of breaking laws, and Howell's integrity was never put on the line. But those who knew him began to wonder if he had something in common with two other CFOs in the news at the time Andrew Fastow at Enron and Scott Sullivan at WorldCom. Friends started asking him, "Are you going to jail?"

For Howell and The Nature Conservancy, and for scores of other charities, the Post series was a wake-up call. Like its for-profit kin, Nonprofit America is being pressured to be more accountable to its constituents. Donors, taxpayers, regulators, and legislators are demanding greater transparency from nonprofits, in both finances and operations. Moreover, donors increasingly want to know how much value their contributions are creating (see "How Effective Is That Charity?").

Adding to the pressure is the Sarbanes-Oxley Act of 2002. Although most Sarbox rules apply only to publicly held for-profit firms, the spirit of the law clearly applies to all enterprises. Nonprofit directors drawn from the corporate world are now asking why the law's reforms shouldn't apply to nonprofits as well.

An Erosion of Trust

While the calls for nonprofit accountability have grown in volume, they aren't new. Episodes of fraud, incompetence, and abuse have gripped the charitable sector over the years, and nonprofit executives have taken their lashes in the court of media opinion. "You have a general erosion of trust in institutions that 40 years ago people trusted without question," says John H. Graham IV, president and CEO of the American Society of Association Executives, in Washington, D.C.

That erosion has been accelerated by high-profile falls from grace. One occurred in 1995, when William Aramony, the former president and CEO of United Way of America, was convicted on numerous charges, including fraud, and subsequently served more than six years in federal prison. More recently, the American Red Cross came under fire when, awash in donations after the 9/11 terrorist attacks, the charity allocated a big chunk ($264 million of $564 million) to reserves for future attacks. Although the practice of adding to future reserves was long-standing, donors unaware of the practice were outraged, and the Red Cross was forced to reverse course.

Another major scandal surfaced in 2002, when the United Way of the National Capital Area (UWNCA) came under investigation. Its former CEO, Oral Suer, stole $497,000 from the charity, whose headquarters are a stone's throw from Capitol Hill. Washingtonians were appalled.

Then came The Nature Conservancy revelations, which angered politicians like Sen. Chuck Grassley (R-Iowa). "People should have confidence that when they write a check for charity, the money will help the needy, not the greedy," stated Grassley last year. Grassley, who is chairman of the Senate Finance Committee, is leading a crusade to rein in excessive tax write-offs and improve nonprofit oversight.

Scandals aside, three other factors are drawing attention to the nonprofit sector:
Mushrooming growth. In the last five years, according to the Urban Institute, the ranks of registered nonprofits have swelled from 1.2 million to 1.4 million, up 17 percent. Meanwhile, revenues have soared from $1.4 trillion to $2.1 trillion, up 50 percent, and assets have rocketed from $2.1 trillion to $4.1 trillion, up 95 percent. An increase in service revenue and the ramping up of family foundations account for much of the growth. The money alone, inevitably, creates suspicion.

Tax-avoidance issues. The Internal Revenue Service loses millions to write-offs stemming from the sector's tax-exempt status. IRS commissioner Mark Everson pointed out in an April Senate hearing that one of the IRS's four five-year objectives is to deter abuse within the tax-exempt sector and to close at least a portion of what he calls the "tax gap." The "gap," at more than $300 billion for all taxpayers, is the difference between taxes owed and taxes actually paid.

The rise of watchdog groups. The public's appetite for open-book management has greatly increased, in part because of the Internet. Watchdog groups like BBB Wise Giving Alliance and GuideStar load their Websites with financial documents and research reports. GuideStar offers downloads of IRS Form 990s (the annual information returns) for some 350,000 nonprofits; more than 20,000 people visit its site each day. The alliance issues reports on 500 nonprofits, and visitors to its Website downloaded a half-million of them in the six weeks following the devastating tsunami in December 2004.

Obviously, the time has passed when outsiders took for granted the good intentions of nonprofit CFOs and audit committees. Grassley, Everson, and others who speak from bully pulpits in Washington want finance officers to install better controls, produce more-extensive audited documents, and give much more performance information to the board and the public.

The people who police charities from state capitals want much the same thing. "This is turning into a cottage industry for attorneys general," says Thomas McLaughlin, senior manager for Grant Thornton's not-for-profit practice. During last year's state legislative sessions, legislation was proposed in 19 states to tighten up regulation of nonprofits, according to Independent Sector, a nonprofit think-tank-*cum*-trade-group based in Washington, D.C. So far this year, 24 such bills have been introduced in 15 states, according to the National Council of Nonprofit Associations.

Wrong Way at United Way
Few cases provide better evidence that nonprofits need closer oversight than the UWNCA fraud. A forensic audit in 2003 confirmed that longtime CEO Suer, who retired at the end of 2001, had loaded up on unreimbursed advances, questionable vacation and sick-leave cash payments, and excess deferred pay. His wrongdoing dated as far back as 1976.

By 2001, after years of siphoning off cash at every turn, Suer had cultivated a help-yourself-and-hide-the-details culture. Some employees took reimbursements for the tax liability they accrued for personal use of United Way cars. They cashed personal checks and had the finance department hold them until they had money to cover them   a short-term loan by any name. Meanwhile, board members apparently ignored repeated signs of fraud. As early as 1986, according to auditors, at least one director was alerted that Suer had unreimbursed advances amounting to well over $500,000. Wrote the auditors: "We could not find evidence that any immediate action was taken...to alert the full Board and the giving public to the existence of these large unreimbursed advances."

When the news broke of the scale of the fraud, donors slammed their checkbooks shut. In 2003, contributions to the UWNCA dropped by two-thirds, from $95 million to $34 million.

Suer eventually pled guilty to defrauding the United Way; he was sentenced in May 2004 to 27 months in prison and ordered to pay $497,000 in restitution.

The UWNCA case was still fresh in the public's mind when the *Washington Post* published its series on The Nature Conservancy. Many people were angered by the size of McCormick's home loan, bonus, housing allowance, and salary even if the salary was in line with those of CEOs at similar organizations. And many were troubled by news of the Conservancy's close relations with business interests, including revelations of oil and gas drilling on a preserve in Texas. Conservancy executives might not have broken the law, but Conservancy members and supporters felt the nonprofit had broken their trust.

Others were galled by the Conservancy's so-called conservation buyer deals. In those deals the Conservancy sold, at a discount, land that it first encumbered with development restrictions. In several cases, Conservancy insiders bought the land in deals that allowed them to build the homes they wanted. To make the Conservancy whole, the buyers wrote checks as donations and then took tax deductions.

The *Post* series spurred an investigation by the Senate and added fodder to the Senate Finance Committee's larger study of the entire charitable sector's business practices and tax abuses. The committee held wide-reaching hearings in June 2004 and April 2005, with others in the offing. In early June, a special report on the Conservancy was issued, and a hearing on the organization was held. New legislation on nonprofit accounting, oversight, and transparency is almost assured.

Cleaning Up

With the Senate on the warpath, many nonprofits have raced to clean up their acts. Independent Sector has convened a panel to recommend reforms; its report was scheduled to be released during the third week of June. Meanwhile, in a September 2004 Grant Thornton poll of more than 700 nonprofits, 83 percent reported familiarity with Sarbanes-Oxley, up from 56 percent in 2003. Nearly half had changed policies as a result, up from 20 percent in 2003. Eighty-four percent reported having an audit committee, up from 77 percent in 2003.

Still, despite such progress, the poll showed that only a third of nonprofits maintain a high level of documentation on internal-control policies. And more than half have a combined audit and finance committee, a worrisome conflict.

The Nature Conservancy was quick to upgrade its policies. The group's audit committee chief, Pete Correll, CEO of Georgia-Pacific Corp., asked Howell in January 2003 to evaluate Sarbanes-Oxley for its relevance to the Conservancy. After Howell did a gap analysis, the Conservancy adopted a number of Sarbox provisions, including a whistle-blower policy, an audit-committee charter, and standards for ethical conduct.

But the Conservancy decided to hold off on certifying financial statements and adopting Section 404 provisions. Both promised to cost too much in hard-won donor contributions to warrant quick action. At first, Howell thought that certifying would be easy. Then he met with a counterpart at Goldman Sachs, whose chairman and CEO, Henry M. Paulson Jr., is also chairman of the Conservancy.

"It was mind-boggling in terms of the people involved and the cost," Howell says of the process necessary for Paulson to sign off on the financial statements at Goldman Sachs. Likewise, Howell realized he would have to set up a chain of people to certify the Conservancy's numbers at each organizational level. "That's a fairly daunting requirement," he says, given his roughly 20,000 cost centers and 1,000 daily transactions.

Howell did beef up disclosure on Form 990, appending a 36-page list of organizations receiving grants from the Conservancy. He also added new footnotes, enough to clarify CEO McCormick's compensation, and continued to break out the value of land versus "conservation easements" (development rights acquired to protect conservation land). At about 100 pages, the Conservancy's 990 now runs twice as long as before.

Howell also added a quality-control process, in which internal audit and each department double-check the 990 line by line. The CFO estimates the extra checking costs the Conservancy $10,000 a year, and has doubled the time he spends on the document. But he figures that's just the new cost of quality control. "If there's a mistake in there," he says, "even if it's a misplaced decimal point or typo, and it's highlighted [by the press], it's embarrassing."

All this was not enough to please Senator Grassley. "Time and time again," he said in comments issued on June 7, "The Nature Conservancy's Form 990s provide only bare-bones information, if any at all, regarding its participation in transactions with insiders as well as unique and complex programs such as...its conservation buyer program." Other senators were not so critical at the June hearing. Sen. Jay Rockefeller (D-W.Va.) referred to Conservancy reforms to date as a "gold standard" for other nonprofits.

The Good, the Bad, the Ugly
UWNCA took its reforms much further than The Nature Conservancy. CEO Chuck Anderson, who began at the organization just six weeks before release of the forensic audit in August 2003, embraced a disclose-everything approach even before he was hired. In Anderson's job interview, the board asked how he would share the upcoming audit's bad news with the public. "I'd take that sucker and put it right on the Web," he recalls saying. "Let the whole world read the good, the bad, and the ugly about this organization."

Today, UWNCA has adopted a full repertoire of rules aimed at assuring total accountability and transparency. It voluntarily complies with every Sarbanes-Oxley reform, including all those related to audit-committee requirements, financial-statement certification, and Section 404 internal-controls procedures.

Of all the reforms, financial-statement certification was the biggest worry for Anderson and Kim Tran, who became CFO in August 2004. That's because, for starters, they had to sign off on numbers from their predecessors. "It was a struggle for us," says Tran. But she insisted on testing entries herself, until she and Anderson were satisfied. "I always do my own testing above and beyond what the auditors do anyway," she adds. Today, says Tran, "I can stand behind every number I have in the books."

The cost, of course, has been a burden. Although Anderson doesn't quantify compliance figures, he has a ready handle on the price of past abuses: roughly $1 million in legal fees, $300,000 for auditing fees, and tens of millions of dollars in lost donations. But he has no regrets about putting on the straitjacket of reforms. "Either way you're going to pay," he says if not for the controls and disclosure, then for the abuse somewhere down the line. "We're the poster child for nonprofit abuse," he adds with a sigh.

Anderson estimates that the full recovery of the public's trust will take 10 years, and UWNCA has entered just the second year of that effort. Anderson and Tran are counting on open-book management, however, as a way to make amends and turn the organization around. "If we had not communicated and been transparent, the gains we have made over the past two years wouldn't have been there," says Tran.

Agenda for Reform
UWNCA is a rare bird, of course. Most nonprofits feel it's premature to adopt all the items on the reformers' menus, and are waiting for clearer signals from lawmakers. Diana Aviv, president and CEO of Independent Sector, believes new regulations under discussion will at least require electronic filing of Form 990, audited financial statements for nonprofits with more than $2 million in revenues, and the signing of returns by the CEO, CFO, or a responsible trustee.

Senate Finance Committee insiders say the reform panel established by Independent Sector carries great weight with Grassley and committee ranking member Max Baucus (D-Mont.). What may concern the senators most is that nonprofit boards are asleep at the wheel that directors think they were appointed for ribbon cuttings rather than for actively managing their institutions. As for financial transparency, the insiders say the Senate has obtained enough

research data to confirm their view that Form 990s are frequently incomplete and inaccurate, filled out inconsistently, and filed late and, therefore, must be reformed.

With that in mind, Aviv says, the nonprofit CFO "has a heightened role now more than ever." She urges finance chiefs to work with executives and the board to beef up oversight, accountability, and transparency. Her recommendations: institute conflict-of-interest policies; conduct regular audits; have a financially literate board; help CEOs understand Form 990; establish procedures for setting executive compensation; and, in particular, make sure noncash gifts are not overvalued by donors (this problem has lately become a lightning rod for criticism).

What all this means is that nonprofit CFOs cannot interpret the call for transparency narrowly; the concept means much more than issuing full financial figures. It involves putting on display clear and candid procedures for running the entire enterprise from how financial statements are assembled and audited to how the auditor operates and how the organization vets insider transactions. Instead of settling for financial transparency, says the American Society of Association Executives's Graham, nonprofits should be working to achieve process transparency.

In the future, nonprofits will need to convince an increasingly skeptical public that they have the right systems and policies in place to ensure that all donations will be spent wisely. "It's not about money," observes Graham. "It's about return on investment. It's about a social or educational or charitable return on investment."

Bill Birchard is a freelance business writer based in Amherst, New Hampshire. His most recent book is on The Nature Conservancy, called Nature's Keepers.

How Effective Is That Charity?
Have you asked about its impact measures?

To gauge the performance of nonprofit groups, outsiders invariably rely on a couple of traditional ratios: administrative costs as a proportion of total costs and fundraising expenses as a percentage of dollars raised. "Those ratios are so deeply entrenched in the way people approach evaluating the effectiveness of charities," says Art Taylor, president of charity watchdog BBB Wise Giving Alliance, "that it would take something on the order of the smoking-cessation movement to get people off of those stats and onto real information that matters."

Real information that matters? In the same way that for-profit ratios like price/earnings and SG&A/total expenses tell little about whether a business delivers value, nonprofit ratios like "efficiency ratio" and "fund-raising ratio" tell little about whether nonprofits do the same. To bridge this information gap, nonprofit experts like Taylor talk about "impact" or "outcome" measures. Quantifying impact or outcome helps donors see beyond fiscal efficiency to mission effectiveness.

One charity that has bridged the efficiency-effectiveness gap is the American Heart Association. CFO Walter Bristol says that up to the mid-1990s, the association set targets by annually increasing fund-raising budgets or by raising goals for the number of people their programs reached. "While we made incremental improvements," he says, "we really did not do things in a fashion that we considered to be bold."

But with the launch of a new strategic-planning process, the Dallas-based healthy-heart advocacy group, with $653 million in annual revenues, put in place one grand "impact" goal: to reduce coronary heart disease, stroke, and key risk factors by 25 percent by 2010. Remarkably, the goal measures the entire U.S. population, not just an isolated group the association can control.

"Now that's a big bold goal," admits Bristol. "The question is, how do we get that done?"

One way Bristol and CEO M. Cass Wheeler hope to get it done is by holding the organization's feet to the fire with its performance measures: the rates of coronary heart disease, stroke,

uncontrolled high-blood pressure, obesity growth, and diabetes growth; and the prevalence of tobacco use, high cholesterol, and physical activity.

Already halfway toward its target year, the association has made steady progress. The impact goal serves as a powerful tool not only to show donors that their money goes to many well-intentioned programs, but that it gets results. Death rates of coronary heart disease, as of March 2005, have declined by 12.7 percent since 1999. Death rates for stroke have declined by 9.1 percent.

As at the American Heart Association, CFOs and finance people are the ones naturally positioned in all nonprofits to give accountability new meaning. "The CFO in the nonprofit sector really has the ability to lead the change by not waiting for the grant maker to demand it," says Susan Raymond, an author and philanthropy expert at Changing Our World Inc., in New York, "but by instead preparing the institution to produce it whenever the grant maker demands it." *B.B.*

© CFO Publishing Corporation 2006. All rights reserved.