SARBANES-OXLEY: WHAT IT MEANS TO NONPROFITS

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1. Introduction

On July 30, 2002, Sarbanes-Oxley was signed into law. While the law applies, for the most part, to publicly traded corporations, the term "Sarbanes-Oxley" has come to stand for much more than just the American Competitiveness and Corporate Accountability Act of 2002, which is the formal name for what is widely known as Sarbanes-Oxley. For nonprofits, Sarbanes-Oxley means the new climate of accountability and oversight in which they operate. Sarbanes-Oxley itself and other reforms, such as those proposed by the NYSE, AMEX and NASDAQ, have all influenced what observers may now consider to be best practices for nonprofits.

2. What do people mean when they say "Sarbanes-Oxley"?

a. The American Competitiveness and Corporate Accountability Act of 2002

The law itself was signed on July 30, 2002, in response to corporate and accounting scandals, e.g., Enron, Tyco and WorldCom. It was designed to improve public confidence in the accuracy and integrity of financial reporting of public companies and to ensure the independence of auditors and accountants. For the most part, it applies only to corporations with publicly traded securities. The Sarbanes-Oxley Act of 2002 established new rules in the following areas:

- Audits and audit committees
- Compliance and accountability
- Disclosure
- Insider trading and conflicts of interest
- Penalties and enforcement

Specifically, the law provides, among other things, that:

- audit committees must be responsible for appointment, compensation and oversight of the outside auditor;
- members of audit committees must be independent;
- at least one financial expert must serve on an audit committee;
- the CEO and CFO must certify the validity of financial statements;.
- the outside auditors cannot perform non-auditing tasks, and companies
- must hire new auditors at least once every five years;
- annual financial reports must include an assessment of internal controls; and
- corporations are prohibited from making loans to officers and directors.

Two provisions of the law do apply to nonprofits, in addition to publicly- traded corporations.

- It is illegal to punish a whistleblower in any way.
- It is illegal to destroy documents to prevent their use in official proceedings.

b. The current climate of accountability and oversight

Corporate governance is under scrutiny generally after the Enron-type scandals. Nonprofits are not just experiencing fallout from the corporate world, however. Press accounts of alleged mismanagement or the lack of accountability at some of the nation's most prestigious nonprofits have drawn public attention to the nonprofit sector.

Congress is not the only regulator that has influenced the conversation about appropriate governance practices for nonprofits today. For example, Sarbanes-Oxley does not include a requirement for independent directors. However, the NYSE has proposed to the SEC to change its listing rules to require that every listed company have a majority of independent directors. No director qualifies as independent unless the board determines that the director has no material relationship with the company, and material relationships include those that are charitable in nature. The NYSE also has proposed that boards have wholly independent compensation and nominating committees and that listed companies must adopt and disclose corporate governance guidelines and codes of ethics, which address, among other things, conflicts of interest.

The relationship between corporate directors and charities also has drawn attention. Enron involved allegations that company insiders were able to influence the judgment of a director by making contributions to a charity headed by that director. Although it is not entirely clear, the effect of the NYSE's "material relationships" provision seems to be that a director would not be independent if the company gave $ 1 million to a charity of which the corporate director or the family was an employee. Most recently, in the uproar of Richard Grasso's compensation package as head of the NYSE, it was disclosed that, in 2002, the NYSE and its foundation contributed more than $1.3 million ~ about 18 percent of total giving — to groups affiliated with members of the NYSE board's compensation committee.

Trustee compensation also is in the news. In September 2003, the Center for Public and Nonprofit Leadership at the Georgetown Public Policy Institute, released "Foundation Trustee Fees: Uses and Abuses." Researchers reviewed Form 990- PFs of 238 private foundations and made follow-up phone calls. Board trustees received fees from 64 percent of the largest foundations and 79 percent of smaller foundations surveyed. The report found that, in general, trustees spend little time on foundation business. The report recommended limiting private foundation trustee fees to no more than $8,000 per trustee a year, prohibiting foundations from counting trustee fees as part of their annual minimum required charitable spending, and using the excise tax paid by private foundations to enable the IRS and state attorneys general to better monitor nonprofits.

Nonprofit leaders should care about Sarbanes-Oxley because it has redefined best practices in governance for all organizations.

3. Who cares about nonprofit accountability?

a. Internal Revenue Service

The IRS, in Announcement 2002-87, asked for comments to improve Form 990 and noted "that there are similarities between the need for veracity in the public information used by shareholders in making investment decisions and the need for veracity in the public information used by contributors and others in making decisions regarding exempt organizations." The IRS asked whether Form 990 should require organizations to disclose whether they have conflict of interest policies and independent audit committees and whether they engage in transactions or have financial relationships with insiders. The IRS asked for any other changes that would increase public confidence in the integrity of exempt organization financial disclosures.

b. U.S. Treasury Department

The "Anti-Terrorist Financing Guidelines: *Voluntary* Best Practices for U.S.-Based Charities," released in November 2002, included a long list of practices under the categories of "Governance," "Disclosure/Transparency in Governance and Finances," and Financial Practice/Accountability." The Guidelines were drafted to give charities greater confidence that their assets are not being diverted to terrorist uses and to reduce the risk that charities' assets would be frozen because they were being diverted to terrorist uses. Among the suggested best practices are establishing that a board is not independent if more than 20 percent of its members are compensated directly or indirectly and making all records of board decisions available for public inspection..

c. State attorneys general

Eliot Spitzer, Attorney General of New York, proposed extending some of the Sarbanes-Oxley provisions to New York nonprofits in early 2003. His proposal would have required nonprofit CEOs to certify financial reports and the adequacy of internal controls, to demonstrate that audit committees are independent and free of contract relationships with the nonprofit. It would have applied to all nonprofits incorporated in New York with annual revenues of $250,000 or more.

Mike Hatch, Attorney General of Minnesota, undertook an 18-month long financial audit of Allina and Medba, Allina's health plan. The audit uncovered excessive spending by the health system and disclosed hidden administrative expenses that were twice the amount reported to the Minnesota Department of Health. The state settled out of court with an MOU requiring Allina to spin off its 501(c)(4) HMO and replace certain board members. The AG's website now offers sample policies to govern operations and conduct of board members, officers, directors and employees and explains that the policies are based on those adopted by Allina and Medica in connection with the AG's compliance review. The policies cover conflicts of interest, travel and entertainment, ethics, sexual harassment, third party contracts, and outside counsel.

d. Watchdog groups

In recent years, groups have formed to help donors give their charitable dollars wisely. The most well known of these groups, BBB Wise Giving Alliance, has adopted Standards for Charitable Accountability that do not just evaluate charities based on their effectiveness, fundraising and informational materials, and financing.

They also monitor Governance and Oversight. The Standards require a board of directors that provides adequate oversight of the charity's operations and its staff, 90 percent of board members to be uncompensated by the organization, and no transaction(s) in which any board or staff members have material conflicting interests with the charity resulting from any relationship or business affiliation.

The Standards explain that adequate board oversight includes, but is not limited to, regularly scheduled appraisals of the CEO's performance, evidence of disbursement controls, such as board approval of the budget, fund raising practices, establishment of a conflict of interest policy, and establishment of accounting procedures sufficient to safeguard charity finances.

Donors, the media and other constituents
The appearance of impropriety can be almost as damaging as actual financial wrongdoing in the eyes of potential donors. Responding to concerns about internal governance brought to public attention by a newspaper story can have many negative effects on an organization. It can embarrass officers and directors and make recruitment and retention of directors very difficult. It can hurt an organization's ability to raise funds for its charitable purposes. It can distract an organization from pursuing its mission.

The San Jose Mercury News got national attention for its stories on the James Irvine Foundation's compensation scandal. As a result, even newspapers that had not covered nonprofits, began to do so. Some have dedicated reporters on the beat. For example, the New York Times has Stephanie Strom and the Washington Post has Jacqueline L. Salmon. The Wall Street Journal and the Boston Globe regularly cover charities and foundations, as well. Regional papers have been picking up the national stories and plugging in a local charity or foundation as a hook for the readers. For example, after the Eisenberg trustee compensation study was covered in the national newspapers, local papers and business journals across the country picked up the story to headline an article typically titled something like, "Local Foundation Among Highest in Pay to Trustees."

4. Best practices for nonprofits now include:

a. An independent and competent audit committee
Make sure that you have an audit committee of the board whose members are not compensated by the organization and who have no material conflict of interest. No staff members or consultants should sit on the audit committee. At least one member of the committee should really understand financial statements. Other members should receive appropriate training to perform their duties. Ideally, an audit committee would be separate from the finance committee. Oversight of any organization by an independent and competent audit committee can help demonstrate that the board of directors has exercised reasonable care in the performance of its duties.

b. Independent and adequately informed outside auditors
The audit committee should have sole responsibility for hiring the outside auditor and meet with the auditor without staff present at the end of an audit. It is important that the organization change auditors frequently enough to ensure that the auditor remains independent. Sarbanes-Oxley mandates a change every five years.

In addition, to ensure that the auditor is independent, the auditor who audits financial statements should not be same one who keeps the nonprofit's books. The.20 audit committee should make it clear to staff that all relevant information must be disclosed to the auditor. The audit committee also should make it clear to the auditor that it wants to hear about any questionable practices or policies within the organization, even if they do not rise to the level of a reportable condition under accounting rules.

c. Timely and accurate financial statements

If the CEO of an organization is capable of evaluating the accuracy of the Form 990-PF and financial statements, having the CEO attest to that fact is desirable. However, CEOs of nonprofits might not be expert in accounting, it is important that the organization has evaluated and documented its internal controls. At a minimum, the board should make sure that procedures are in place so information is gathered and available on a timely basis. Form 990-PFs should be filed on time absent special circumstances.

d. Caution about insider transactions

Sarbanes-Oxley prohibits loans to directors and officers of a company, which is more restrictive than the IRS rules for nonprofit organizations. If an organization decides to engage in a transaction with an insider, it should have a conflict of interest policy governing such transactions.

The tax code provides for a rebuttable presumption that compensation is reasonable when an organization follows certain procedures, which represent best practices, in approving the transaction. The requirements for earning the presumption of reasonableness are as follows: (1) the arrangement must be approved in advance by members of the organization's board or a board-appointed committee, none of whom have a conflict of interest; (2) the board or committee must have obtained and relied upon "appropriate data" as to the comparability of the compensation or fair market value of the consideration; and (3) the board or committee must document the basis for its determination adequately and contemporaneously.

e. Transparency and disclosure

This addresses, in part, the two Sarbanes-Oxley provisions that apply to nonprofits: no punishing whistleblowers and no destroying documents to prevent use in an official proceeding. A nonprofit can avoid whistleblower problems by eliminating the need to blow the whistle. It can do this by instituting a formal complaint process for employees and a transparent process for reviewing those complaints. A nonprofit also should adopt a written formal policy on document destruction. It will limit accidental destruction of documents and help to show that when destruction occurs, it is not aimed at investigation. A policy should specify that once an investigation begins, all destruction should cease.

Nonprofits also, as mentioned, must ensure that their 990-PFs are filed on time.
Their audited financial statements should also be available for review.

5. What should a nonprofit do now?

Compare the policies and practices in place at your organization to the best practices in accountability. Take a risk-based approach. Consider how much you can afford to do. Large financially secure nonprofits can afford to spend a fair amount on improving its accountability mechanisms. Given the amount of money flowing through the organizations, it may be hard to justify a decision not to improve accountability for those funds. On the other hand, a struggling nonprofit with few financial resources can adapt its response to Sarbanes-Oxley-type concerns based on its ability to do so.