Non-Profit Governance In The Wake Of Sarbanes-Oxley

Katherine E. David

Katherine E. David
is an associate in the San Antonio office of Oppenheimer, Blend, Harrison & Tate, Inc. She is a member of the ABA Section of Taxation and General Counsel of VISION-San Antonio.
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This is another in a continuing series of articles written by members of the ABA Tax Section in which a senior member of the section teams up with a member selected from the Young Lawyers Forum.

ISSUES OF CORPORATE GOVERNANCE (and the fall-out when good governance is lacking) have featured prominently in recent headlines. The Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley") is a significant portion of the government's response to these issues. Sarbanes-Oxley is directed at publicly held companies that have registered with the U.S. Securities and Exchange Commission ("SEC") under the Securities Act of 1934 and, among other things, seeks to promote corporate responsibility, enhance accountability, and improve the quality and accuracy of financial reporting.

With all the media attention and professional discourse directed towards Sarbanes-Oxley, it is natural for leaders of organizations not technically subject to Sarbanes-Oxley (both for-profit and nonprofit) to ask what effect it has on them. This article will examine how Sarbanes-Oxley applies to exempt organizations and will discuss legislation and guidance specifically targeted at exempt organizations.

THE SARBANES-OXLEY ENVIRONMENT • In examining Sarbanes-Oxley, one should remember the particular period during which it was adopted. A few

decades ago, the country was concerned with encouraging entrepreneurial spirit and initiative, not with regulation and ensuring transparency and accountability. As recently as the 1980s, almost every state enacted volunteer protection statutes giving immunity from liability to volunteers, including officers and directors, for a wide variety of actions. Although these statutes were not uniform, the common theme among them was to raise the "liability threshold." Soon after, the Federal government enacted its own volunteer protection legislation, the Volunteer Protection Act of 1997. The Act provides that if a volunteer is acting within the scope of his or her responsibilities and meets certain criteria, he or she has a complete defense against third-party actions (but not actions by the organization). When the Act applies, a volunteer is liable only when there is willful or criminal misconduct, gross negligence, reckless misconduct, or conscious flagrant indifference to the rights or safety of the person harmed. With Sarbanes-Oxley and proposed similar legislation directed specifically at exempt organizations, the accountability pendulum has swung to the other side. Without insinuating that Sarbanes-Oxley is not appropriate for large public companies, it is important to recognize that Sarbanes-Oxley is but one end of the spectrum of reasonable legislation, and that exempt organizations may not need to implement its provisions across the board to protect themselves.

One often hears Sarbanes-Oxley discussed in conjunction with "best practices." Even this term is a bit of a misnomer in the Sarbanes-Oxley context. The Sarbanes-Oxley regime is in its early stages, and it is not yet clear that the requirements it imposes will have the intended result. Even if the provisions prove to be an effective antidote to problems that plague large, publicly traded companies, it is not clear that they will have the same salubrious effect (such that they can be called "best practices") on exempt organizations.

Prudent directors of exempt organizations would be wise to examine the "best practices" codified in Sarbanes-Oxley. To the extent that Sarbanes-Oxley was designed to promote corporate responsibility and accountability, it can be read as guidelines for any organization. At the same time that nonprofit directors familiarize themselves with the provisions of Sarbanes-Oxley, they should bear in mind that the act was designed to address specific issues in the approximately 14,000 companies registered with the SEC that have availed themselves of the public financing necessary to offset the costs of compliance. Thus, Sarbanes-Oxley is not necessarily a cure-all—or even a realistic standard—for the ills of the nonprofit sector.

Regardless of how strictly nonprofit leaders choose to apply the other provisions of Sarbanes-Oxley to their own organizations, the language of two provisions of Sarbanes-Oxley, dealing with destruction of documents and retaliation against whistle-blowers, is broad enough to encompass directors of nonprofit organizations. It is imperative that nonprofit advisors are aware of these provisions and the penalties for their violation.

SARBANES-OXLEY PROVISIONS • This section provides a brief overview of certain requirements of Sarbanes-Oxley. Most of the provisions do not apply to nonprofit organizations, except, perhaps, to suggest "best practices." Throughout this discussion, the reader will be encouraged to put Sarbanes-Oxley, and the effect it will have on exempt organizations, in context.

This section also deals with the whistle-blower and document-destruction provisions, which are drafted broadly enough to encompass all organizations, including nonprofit and exempt organizations. Attorneys who form these organizations should consider addressing these issues in their organizational documents or in stand-alone written policies adopted alongside the bylaws at the organi-

zational meeting. Attorneys who represent existing nonprofit organizations should consider causing their clients to formally adopt whistle-blower and document-destruction policies. Rather than adding these policies to its bylaws (and undertaking the administrative task of amending the bylaws), an organization might simply adopt written policies.

Audit Committee Requirements

Sarbanes-Oxley section 301 requires the audit committee of a company's board of directors to appoint, determine the compensation of, and oversee the auditor's work. The audit committee must be independent; its members may not be affiliated with the company or its subsidiaries, and they may not receive fees from the company beyond their compensation for serving on the board of directors and the audit committee. Sarbanes-Oxley section 407(a) encourages companies to have financial experts on the audit committee by requiring companies to disclose whether their committees comprise at least one financial expert and, if not, the reasons why such an expert is missing from the audit committee.

Smaller exempt organizations, for which an outside audit would be an unreasonable financial burden, should, at the very least, have their financial statements compiled by a professional accountant and should consider having an outside review of their financial statements.

The audit committee provisions of Sarbanes-Oxley are guidelines for how exempt organizations can enhance the effectiveness of their audit committees and ensure their financial integrity. Though directed at for-profit entities, these provisions also are suited to the nonprofit world; some large nonprofits should be able to implement the Sarbanes-Oxley provisions with ease. Those organizations that are able to conduct outside audits should consider having an audit committee separate from the finance committee and, when possible, should model that committee to fit the requirements of Sarbanes-Oxley (e.g., the committee should have a financial expert, should be independent, etc.).

Private foundations might have difficulty implementing the Sarbanes-Oxley requirements. Private foundations typically have small boards that include directors who receive compensation for services other than their service to the board. This conflict is not terribly troubling, however, because the self-dealing rules imposed on private foundations by Internal Revenue Code ("IRC") section 4941 reduce the need for audit committee independence. *See* Daniel L. Kurtz, *Nonprofit Governance* (2003), available at www.hklaw.com/content/Webarticles/kurtzarticle.pdf.

Smaller exempt organizations, for which an outside audit would be an unreasonable financial burden, should, at the very least, have their financial statements compiled by a professional accountant and should consider having an outside review of their financial statements. Although nonprofit boards should not hasten to satisfy all of the audit committee requirements of Sarbanes-Oxley in their organizations, they should recognize that Sarbanes-Oxley signals the importance of proper and appropriate financial housekeeping.

The American Institute of Certified Public Accountants ("AICPA") has promulgated tools to assist exempt organizations in forming audit committees. These tools are included in *The AICPA Audit Committee Toolkit: Not-for-Profit Organizations* available for download or purchase at the AICPA website: www.aicpa.org.

Auditor Provisions

Sarbanes-Oxley section 202 prohibits auditors from providing certain non-auditing services along

with an audit unless the audit committee pre-approves non-audit services (such as tax services, bookkeeping, appraisal and actuarial services, management or human resources services, legal services, etc.), and discloses all approvals of non-audit services. Sarbanes-Oxley section 203 requires that the lead audit partner and the lead review partner overseeing a company's audit be rotated off their engagements after five years, and section 206 prohibits an auditor from providing audit services to a company if the auditor employed the company's CEO, CFO, Chief Accounting Officer, or controller and such individual participated in any way in the audit of the company within one year before the initiation of the audit.

The audit committee provisions increase communication between the audit committee and the auditor, place responsibility for all aspects of the audit with the audit committee, and enable the auditor to act without conflict of interest.

Exempt organizations should consider self-imposing certain of these requirements to ensure their auditors are independent and to maintain the integrity of their audits and the accuracy of their financial statements. Changing auditors every five years is a reasonable practice for all organizations, and by preventing auditing firms from providing non-auditing services, exempt organizations can avoid conflicts of interest. It is good practice for nonprofit managers to report critical accounting policies to the audit committee (where one exists). Such reporting allows the audit committee to make more informed judgments and produces greater transparency. Organizations also can promote transparency between management and the audit committee by having the CFO or other financial officer report directly to the audit committee as well as to upper management, and by making the chair of the audit committee available as a point of contact for whistle-blowers.

At the same time, as with the other provisions of Sarbanes-Oxley that do not actually apply to exempt organizations, nonprofit directors should take a measured approach to the audit provisions. The audit committee should consider pre-approving certain non-audit services to be performed by the auditor, particularly preparation of the Form 990 or 990-PF. Although exempt organizations should take care in using their auditing firms to provide non-auditing services, in many cases the concerns are outweighed by the economies of appropriately using the same firm for multiple services.

An exempt organization should have a written document retention and periodic destruction policy. Such a policy would address the fact that while the organization needs to maintain appropriate records about its operations, it also needs to dispose of unnecessary and outdated documents on a regular basis.

Document Destruction

Although the Sarbanes-Oxley provisions on auditors and audit committees can be read as suggested practices for exempt organizations and their directors, nonprofit directors are subject to the provisions on document destruction. Sarbanes-Oxley section 1102 makes it a crime, punishable by fine or imprisonment for up to 20 years, to corruptly alter, destroy, mutilate, or conceal a record, document, or other object, or to attempt to do so, with intent to impair the object's integrity or availability for use in an official proceeding or to otherwise obstruct, influence, or impede any official proceeding, or to attempt to do so. (An audit by the Internal Revenue Service presumably would be an official proceeding.)

An exempt organization should have a written document retention and periodic destruction policy. Such a policy would address the fact that while the organization needs to maintain appropriate records about its operations, it also needs to dispose of unnecessary and outdated documents on a regular

basis. The policy should include rules for handling electronic files and voicemail, which have the same status as paper documents in litigation. The policy should provide that when an official investigation or proceeding is undertaken, all document purging should be suspended.

Whistle-Blower Provisions

Under Sarbanes-Oxley, anyone who knowingly, with the intent to retaliate, takes any action harmful to any person, including interfering with the person's lawful employment or livelihood, in response to such person's providing to a law enforcement officer any truthful information relating to the commission or possible commission of any Federal offense, is subject to fine or imprisonment for up to 10 years. Even if the employee's claim is unfounded, so long as the employee had a reasonable basis to believe that fraud existed, he or she is protected under the whistle-blower provisions.

Exempt organizations must develop procedures to handle employee complaints. Ideally these procedures will provide confidentiality and anonymity to encourage employees to report inappropriate activity. Organizations that have audit committees can promote transparency between management and the committee by having the committee chair serve as a point of contact for whistle-blowers.

The American Institute of Certified Public Accountants ("AICPA") has promulgated a sample *Whistle Blower Tracking Report* and sample *Whistle Blower Policy*. These tools are included in *The AICPA Audit Committee Toolkit* available for download or purchase at the AICPA website: www.aicpa.org.

Indirect Application Of Sarbanes-Oxley To Exempt Organizations

Although only Sarbanes-Oxley's document destruction and whistle-blower provisions directly apply to exempt organizations, it would be misguided to assume that the other provisions will not have an indirect effect. The following are some predictions of the effect Sarbanes-Oxley could have in the nonprofit sector.

Sarbanes-Oxley naturally will affect judicial conceptions of fiduciary standards and thus will "raise the bar" for all organizations, including nonprofits. Also, nonprofit board members who also serve as executives at large for-profit organizations may come to accept Sarbanes-Oxley-compliant governance as the standard. Those who do will expect (and perhaps require) the exempt organizations they serve to comply with part or all of the Sarbanes-Oxley provisions.

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Finally, in many ways, nonprofit organizations that solicit donations (particularly IRC §501(c)(3) organizations) contract for accountability. They solicit grant funding, private funding, and government funding, all of which require accountability and transparency. To the extent that Congress has, in Sarbanes-Oxley, codified what "accountability and transparency" look like, organizations could feel outside pressure to meet the Sarbanes-Oxley standard.

EXEMPT-ORGANIZATION-SPECIFIC LEGISLATION AND GUIDANCE • Sarbanes-Oxley was designed to address grievances arising from large, publicly-traded companies and thus has limited direct application to exempt organiza-