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Sarbanes-Oxley And Nonprofits

**by David E. Ormstedt, Esq.*

Ever since Congress enacted the American Competitiveness and Corporate Accountability Act of 2002, more commonly called the Sarbanes-Oxley Act or, for brevity, "Sarbanes" (some use the acronym SOX), people in the nonprofit world and those who advise them, have been discussing and speculating on what it means for nonprofits. The law firm I am with has lately received an increasing number of inquiries. In view of this interest, I thought it would be appropriate and useful to make the relationship of Sarbanes-Oxley to nonprofits the subject of this column.

Sarbanes, as you probably know by now, is Congress' response to corporate abuses perpetrated by the likes of Enron and WorldCom, sometimes with the knowing or unwitting help of their auditors and other so-called professionals. At its most fundamental, Sarbanes is intended to restore public confidence badly shaken by corporate officers who cooked the books to raise their companies' stock prices so they could sell their shares and become even wealthier than they already were. The legislation is designed to promote transparency, accountability and corporate responsibility. To improve the quality and accuracy of financial reporting is one of its goals; but a more overarching goal of Sarbanes is to bring a climate change to corporate board rooms where people all too often are asleep at the switch.

Sarbanes applies to publicly held companies; that is, companies that issue stock that you and I are free to buy if we dare. With two exceptions that I'll explain in a moment, Sarbanes does not generally apply to nonprofits. Nonetheless, many in the sector are, with varying degrees of conviction, urging nonprofits to voluntarily adopt some of the Sarbanes measures. As several commentators have put it: elements of Sarbanes that are adaptable to nonprofits have been added to the compendium of best practices in the nonprofit sector and if you want to stay ahead of the curve you had better incorporate them into your governance and management structure. In fact, don't be surprised if a bill to impose stricter requirements on nonprofits is presented to the Connecticut General Assembly when it convenes in January. New York Attorney General Elliott Spitzer has done just that and the temptation to piggyback on it here may prove too difficult to resist.

As mentioned before, only two Sarbanes provisions apply to nonprofits. They are:

A. Whistleblower Protection. Sarbanes prohibits a corporation from retaliating against an individual who reports suspected illegal activity. To help ensure compliance, each nonprofit should adopt a written policy on handling employee and volunteer complaints. The policy should be included in the employee manual.

People who want to make a complaint should know how to do so and feel confident that a system is in place to address it without fear of retaliation.

B. Document Destruction. Sarbanes makes it a crime to alter, hide, destroy, or falsify documents to prevent their use in litigation or official proceedings. Every nonprofit should develop a document retention and destruction policy and adhere to it. The policy should be guided by document retention requirements already imposed on nonprofits by external forces. For example, charities registered with the state of Connecticut under the Solicitation of Charitable Funds Act are required to keep "true fiscal records" for three years after the end of the fiscal year to which they relate. For the IRS, it's generally three years from the date the return was due or filed, whichever is later.

Although Sarbanes does not generally apply to nonprofits, there are a number of provisions in the law that nonprofits can incorporate into their own governance structure to help avoid the kinds of mismanagement, self-dealing and financial shenanigans caused by lack of proper board oversight. After all, publicly traded businesses and nonprofit organizations are not so fundamentally different as to preclude parallels between the two. Both have constituencies upon whom they depend and whose trust and confidence they must cultivate and preserve. Expert commentary and recent developments make clear that the requirements of the Sarbanes legislation are being drawn upon as nonprofit institutions rethink and transform their governance structures.

The following is a brief overview of Sarbanes provisions that are adaptable to nonprofit organizations. Due to space constraints, there is no attempt here to cover all applicable matters and the reader should not construe it as such. It is simply meant to highlight some of the things on which boards should be focused.

A. Audit Committee.

- The board of directors should have an independent and competent Audit Committee with defined responsibilities. This can be accomplished in a number of ways, including adoption of a bylaw or a resolution creating the committee.
- Each member of the Audit Committee should be a director of the nonprofit and be independent. "Independent" means that a member of the Audit Committee cannot be part of management, including the CEO. This element forces a separation between management and the external auditors.
- Committee members should not receive compensation directly or indirectly from the nonprofit. In other words, they should not have any business relationship with the nonprofit.
- At least one member of the Audit Committee should be a financial expert. For some organizations this will be impractical because there are not that many experts to go around. But at least have someone on the committee who is knowledgeable enough to ask the right questions.
- The Audit Committee (and not management) should be responsible for hiring the auditors, setting the auditor's compensation, and overseeing the auditor's activities. In other words, the committee should "own" the relationship with the external auditors.
- The Audit committee and management should be prepared for tougher scrutiny from its auditor. In direct response to Sarbanes, the American Institute of Certified Public Accountants issued what is called Statement on Auditing Standards No. 99, Consideration of Fraud in a Financial Statement Audit. The Statement applies to nonprofits and for-profits alike. Beginning with audits for fiscal years ended December 2003, auditors are required to dig deep to ferret out fraud. For example, the entire audit team is expected to meet and brainstorm about how if they wanted to steal from the nonprofit how would they go about it. The exercise is intended, in part, to reveal possible internal control weaknesses that management hadn't thought about.

B. The Auditor.

- If the corporation retains the same auditor for a number of years, the lead partner should rotate at least every five years. This element is intended to reinforce auditor independence.
- An independent auditor should generally not perform non-audit services for the nonprofit such as bookkeeping, financial information systems, fairness opinions and the like. However, the Audit Committee may decide to permit the auditor to provide certain non-audit services, such as tax services. This means the auditor may prepare Form 990 for the nonprofit.

C. Conflict of Interest Statements. Most nonprofits already have a conflict of interest policy; but it should be reviewed to make sure that the policy requires annual disclosure of interests and that it includes top management.

D. Internal Controls and Financial Statement Certifications. Sarbanes requires the CEO and CFO to certify that the corporation's financial statements are accurate and fairly present the financial condition of the company. Most nonprofits already provide a form of certification with respect to financial reports.

- Nonprofits registered to solicit funds in Connecticut file financial reports with the Connecticut Department of Consumer Protection. Those reports are required to be signed under penalty of false statement by two officers of the organization, one of which must be the chief fiscal officer.

- The IRS 990 must be signed under penalty of perjury by an officer of the nonprofit.

As you now know, Sarbanes has little direct impact on nonprofits. The indirect effect, however, is a different story. It has undoubtedly raised the bar on expectations for nonprofit governance. Nonprofits would be well-advised to examine their governance structure and internal controls and make necessary adjustments, borrowing from Sarbanes. It is entirely possible that in the future insurance companies will want to see those things in place before issuing a policy.

The effect of Sarbanes on nonprofits could well be overshadowed by something going on right now in Washington DC. The Senate Finance Committee, chaired by Senator Charles Grassley of Iowa, held a hearing in June on misconduct in the charitable sector. The title of the session was "Charity Oversight and Reform: Keeping Bad Things from Happening to Good Charities." The committee staff has developed a discussion paper containing some extraordinary proposals, such as one that would limit the size of a nonprofit's board to fifteen. It's too early to speculate on which of the proposals will gain traction and which will be abandoned as unworkable or politically too hot. As time goes on that will become more apparent. So an in-depth discussion will be left for another column.

**Mr. Ormstedt is with the law firm Wiggin and Dana LLP in its Hartford office. He is a member of the firm's tax-exempt organization practice group. Prior to joining Wiggin and Dana, Mr. Ormstedt was the assistant attorney general in charge of the Public Charities Unit at the Connecticut Attorney General's Office.*