



FOLEY & LARDNER LLP

SOX Impact on Nonprofit Organizations

FOLEY & LARDNER'S 2005 NATIONAL DIRECTORS INSTITUTE

Corporate Governance Reform:

What's Next?

SOX IMPACT ON NONPROFIT ORGANIZATIONS

In the three years after the federal governance reform legislation known as Sarbanes-Oxley (SOX) was adopted in 2002, it has become increasingly clear that the nonprofit sector has been directly affected by the impact of SOX on nonprofit governance best practices. SOX-inspired legislation and regulations also have been enacted specifically to apply to nonprofits.

As part of Foley & Lardner LLP's 2005 National Directors Institute (NDI) held March 10, 2005 in Chicago, panelists and moderators in the breakout session entitled "SOX Impact on Nonprofit Organizations" explained the various sources of pressure and potential regulation currently affecting nonprofit organizations and their visions of best practices within the nonprofit sector.

SOX-Based Legal and Regulatory Developments on Nonprofits

Only two generally applicable provisions of SOX directly impact nonprofits: the whistle-blower protection provision, which prohibits interference with a person who reports a potential infraction to a federal law enforcement agency, and the prohibition of document destruction upon the commencement of a federal investigation.

However, in addition to these two SOX provisions, Richard F. Riley, Jr., a partner in Foley's Taxation Practice Group, described numerous other recent state and federal developments that will affect the corporate governance and accountability of nonprofits and confirm that nonprofits are "in the crosshairs" of government regulators. They include:

Senate Finance Committee/Joint Committee on Taxation

In June 2004, the Senate Finance Committee released its staff "White Paper" that contained a number of proposals to impose under federal law SOX-type governance requirements on the nonprofit sector. An organization's tax-exempt status would be conditioned on compliance with these requirements, which include:

- Restrictions on governing board compensation
- Mandatory audits for organizations with over \$250,000 in annual revenue
- SOX 404 certification by charity CEOs
- New governing board roles (e.g., audit, oversight, etc.) enforced by federal law

In January 2005, the Congressional Joint Committee on Taxation released a series of proposals prepared by the Panel on the Nonprofit Sector. Among

the proposals was an increase of penalty taxes for the misconduct of tax-exempt foundations and charities.

Internal Revenue Service (IRS) Developments

IRS Form 1023, the Section 501(c)(3) tax-exemption application, was completely revised and released as a new version last October. Organizations must declare whether or not they have developed and implemented a conflict of interest policy consistent with the IRS model. If an organization has not adopted such a policy, it must explain its reasons to the IRS, which, Mr. Riley commented, “as a practical matter, means do it.” The new form also has detailed inquiries on compensation of executive and non-executive insiders and consultants. Mr. Riley noted that while the IRS mentioned in early 2004 that the service was working on nonprofit governance best practices, nothing has been published and it is unclear whether that effort is still underway.

The IRS also has publicly announced enforcement initiatives aimed at the compensation of executives of tax-exempt organizations: inquiry letters are being sent to 1,000 or more nonprofit organizations of all categories inquiring about executive compensation practices. Some of those letters are expected to lead to audits.

Finally, Mr. Riley noted that the IRS Commissioner has said that an important enforcement initiative of the IRS concerns the participation by nonprofit organizations in abusive tax shelters.

California Nonprofit Integrity Act

California has enacted the California Nonprofit Integrity Act (Act) based in large part on requirements derived from SOX. The Act became effective on January 1, 2005 and applies to all charities that do business in California, regardless of where the entity is organized. For charities with annual revenues of \$2 million or more — exclusive of government contracts — there is a mandatory outside audit, which will be publicly disclosed. Further, an independent audit committee must hire the auditor and oversee the relationship of the organization with the auditor to ensure that there are no conflicts of interest.

Regulatory Activity by State Attorneys General

Although New York Attorney General Eliot Spitzer had proposed state legislation containing SOX-type governance requirements, he recently announced that his office will no longer seek such legislation and will instead focus on education and communication.

Governance Challenges in Nonprofit Health Care

Richard L. Prebil, a senior counsel in Foley's Health Law Department, outlined the numerous challenges to nonprofit health care governance, of which SOX is only one. The guide words are “transparency” and “accountability.” These forces include

health care fraud, compliance programs, state statutes, state Attorney General actions, property tax exemption challenges, and the recent class actions on charges to the uninsured. All of these forces are incentives to nonprofits to adopt “best practices” in governance.

Nonprofit Organization Responses to SOX Corporate Governance Guidelines

Panelist Robert W. Clarke, Midwest Health Care and Life Sciences Industry Group leader of Deloitte & Touche LLP, spoke on the responses to governance best practices by nonprofit organizations.

Corporate Governance Changes

In general, Mr. Clarke reported that large organizations have “very actively embraced” and adopted the SOX corporate governance provisions because boards and management teams “view them as good governance.” Nonprofit organizations — particularly larger organizations — have created a separate audit committee with independent directors and a designated “audit committee financial expert.” Fred Entin, a partner in Foley’s Health Law Department and chair of the firm’s Health Legislation/Associations Practice Group, added that an organization’s size may help or hinder the search for a financial expert for the audit committee. Mr. Entin stated, “We have seen a huge dichotomy between small organizations and large organizations. It’s easy for [the larger organizations] to find a financial expert. [For] the smaller ones, it may be very difficult.”

The audit committees have been vested with the following powers:

- Appointment, compensation, and oversight responsibility over the external auditor
- Pre-approval of audit and non-audit services
- Engagement in executive sessions with management, the internal auditor, and the external auditor
- Review of financial statements — including major issues regarding financial statement presentation and accounting principles

Nonprofits have been implementing practices derived from the certification requirements of SOX Section 404 and Section 302 at a more moderate pace.

The Relationship of the Independent Auditor and Organization

Independent auditors are now reporting directly to the governing financial oversight committees of nonprofit organizations, not to management. Audit reports now routinely include all critical accounting policies and practices used, all alternative treatment of financial information, other written material communication, and a schedule of unadjusted audit differences.

Mr. Clarke has found that the relationship between accountants and their nonprofit clients has clearly changed in the years after SOX. Audit

committees are now closely scrutinizing the independence of accountants and asking the accountants whether they are independent, but they are not requiring a written statement of independence, as required by SOX. Nonprofits have not generally been requiring accounting firms to rotate the principal partner out of working for a given client after every five years, as required by SOX. Deloitte & Touche, however, enforces a seven-year rotation policy for partners working within the nonprofit sector.

Recently, nonprofits have not been hiring audit engagement team partners into positions of responsibility such as CFO, CAO, and CAE as often as they had in the past. SOX mandates a one-year “cooling off” period before a publicly traded company may hire a partner from the company’s independent accountant into a financial oversight role. Prior to SOX, Mr. Clarke said that many accountants were solicited by their nonprofit clients to join the organization and assume financial roles. Currently, he reported that many nonprofits have adopted that practice even though such a limitation is not required by SOX nor contained in the charters of many nonprofit organizations.

Controls and Officer Certifications and Attestations

There has been “moderate implementation” of officer certification requirements — similar to those under Section 302 of SOX — relating to the completeness and accuracy of financial statements. Some audit committees are asking for the CEOs and CFOs of nonprofits to certify financial statements in a manner very similar to the public sector. The certification statements address the fair presentation of financial statements and information, the lack of known omissions of material facts in the disclosures, and the responsibility to establish procedures to identify required disclosures. These certifications are usually being done on an annual basis, though sometimes quarterly. Also, the governance oversight committees are reviewing debt documents and officer certifications.

Nonprofits have not actively embraced Section 404 of SOX. Although Mr. Clarke stated that there have been situations where a few larger nonprofits have decided to fully implement such requirements over a multi-year period, this is not the standard in the industry. The primary reason is the high costs of full compliance with SOX and the concerns about the source of funding for such expenditures, which some consider unfunded mandates.

Corporate Governance Reforms — Two Industry Perspectives

Donna Wetzler, General Counsel of Children’s Memorial Hospital (Children’s Memorial) and Pamela McElvane, Chief Executive Office of P&L Group, Ltd, a business focusing on diversity business solutions, and a member of a number of nonprofit boards, described the changes in governance practices occurring within their organizations. In addition to discussing their experience in the current

regulatory environment, Ms. Wetzler and Ms. McElvane focused on the different and similar challenges recently presented to large and small nonprofit organizations.

In prefacing their comments, both Ms. Wetzler and Ms. McElvane noted that most of their organization's governance decisions are based on concepts of good governance best practices. The Children's Memorial's audit committee is now separate from its finance committee and the chair of the audit committee has significant accounting experience. The audit committee has a charter, holds executive sessions, and all members of the audit committee are independent. The committee has always used a conflicts questionnaire and, recently, a governance review project has been initiated. Even though Children's Memorial has always used an independent firm to analyze its compensation arrangements, Children's Memorial now also retains outside counsel to review its executive compensation. In addition, Children's Memorial is currently reviewing the role of the corporate secretary to ensure that it "becomes a more professional position and less of a ministerial position."

Both Ms. Wetzler and Ms. McElvane noted that the size of an organization will have an effect on the degree to which an organization can implement changes based on SOX. Also, many charitable boards are historically large and require a robust committee structure with actively engaged members.

Ms. McElvane commented at length concerning the whistle-blower protections in SOX. She recommended that nonprofits of all sizes should strengthen accounting practices, install internal audit processes, and develop written policies to send the message that misconduct within the organization is not tolerated. Further, she suggested that nonprofits develop and distribute a complete employee handbook containing a clear policy of grievance and complaint procedures.

With respect to best practices, Ms. McElvane believes that an organization should introduce the following four components:

- Independent and competent audit committee
- Certified financial statements
- Conflicts of interest
- Disclosure

Ms. McElvane related that in the six years since she joined the board of *StreetWise*, which is a relatively small organization dedicated to meeting the needs among the homeless of Chicago through the operation of a street newspaper, the board has transformed itself from a grass-roots board into a fully engaged governance board. And, she says that while *StreetWise* is too small to have a separate and independent audit committee, "we weren't too small to have a competent person in the position of treasurer" and chair of finance. Also, regardless of size, Ms. McElvane stressed that there will be "no excuses for the lack of" complete disclosure. She suggested

making IRS Form 990s and Form 990(t)s and audited financial information available online.

Ms. McElvane also commented that, especially in the current environment, “board service is not an entitlement,” as it may have been viewed in the past. Instead, she stated that part of “the responsibility of the nonprofit is to drive the change through” and determine how the organization will be constituted. Ms. McElvane suggested that an organization should examine “the attributes and characteristics of the individuals [brought] to the board and use their competencies to help” the organization. Mr. Riley agreed that this shift in the composition of nonprofit boards is “an inevitable change,” noting that the regulatory threats facing nonprofits have rendered obsolete the “older model of nonprofit board membership,” which was built upon “the purely passive board of directors member who is on the board because of the size of his or her contribution.” Further, boards and board committees will need to take responsibility for much of the work that previously was performed by staff “because the legal authorities want the governing board to be responsible” for oversight.

Despite the challenges now facing nonprofit organizations, the panelists are confident that many people remain passionate about board and committee service to nonprofits. As stated by Ms. McElvane, “everybody wants to be affiliated with an organization that’s moving in the right direction.” It is clear that nonprofits are moving in the right direction: many have self-imposed new corporate governance requirements, showing both a response to the changing enforcement environment and also their desire to follow best practices to maintain the public trust.

For More Information

For more information on the “SOX Impact on Nonprofit Organizations” breakout session, please feel free to contact the speakers directly.

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