

The Sarbanes-Oxley Act May Impact Your Not-for-Profit Organization

Accountability, ethics, transparency, duty, full-disclosure, compliance, responsibility ... More than simply buzz words for public sector organizations who want to meet the expectations of their constituents.

Even the smallest not-for-profit organizations (NPOs) interact with or impact a significant portion of the population. Public concerns, expectations, and motives have changed significantly in the past several years. Gone is the blind faith and trust the public historically placed in NPOs because of their perceptions about "inherent goodness" of employees, management, committee members, and/or their governing boards. Some of us even fear that the one million-plus associations, educational institutions, foundations, clubs, churches, and all other types of NPOs will struggle to recover their esteemed position with constituents.

Rather than focus on why things have changed, this document addresses the current business environment, and provides suggestions as to how NPOs can and should react to this change.

The Sarbanes-Oxley Act (the Act) is one of the most significant business related events to impact the commercial marketplace in recent years. As issued, the Act is only applicable to public companies and their auditors. However, special interest groups and oversight agencies have been questioning why it shouldn't be applied, at least in some respects, to the public sector. According to information from the National Council of Nonprofit Associations [NCNA], a number of state legislators and attorney generals are considering various proposals to increase nonprofit accountability at the state level. A chart outlining the current status of impending legislation in various states is posted to the NCNA Web site at <http://www.ncna.org>.

A summary of key provisions of the Act is available on the American Institute of Certified Public Accountants Web site: http://www.aicpa.org/info/sarbanes_oxley_summary.htm. A complete text of the Sarbanes-Oxley Act is located at <http://financialservices.house.gov/media/pdf/hr107610.pdf>.

No one believes all of the problems in the current business environment are restricted to public companies. Therefore, provisions of the Act are beginning to cascade down to the public sector.

Our intent here is to provide a broad view of the Sarbanes-Oxley Act and its key provisions to help you understand why so many constituency groups and oversight agencies are focusing their attention on the Act's application to the public sector even though, as written, they were principally designed for public companies.



Briefly, the Act's principal reforms include:

- Creation of an independent public company accounting oversight board (the PCAOB)
- Auditor independence provisions that restrict non-audit services that accountants may provide to their public audit clients
- A heightened level of corporate governance and responsibility measures
- Expanded corporate, financial and insider disclosure requirements
- Mandatory disclosure by analysts of potential conflicts of interest
- A range of tough new penalties for fraud and other violations

Key Objectives of the Sarbanes-Oxley Act

- Increase investor/shareholder confidence in public reporting
- Increase management's accountability for financial reporting and information disclosed to the market
- Develop a stronger, more independent audit system
- Reduce accounting irregularities/aggressive financial reporting
- Ensure that the internal controls surrounding financial reporting are effective via internal monitoring functions
- Reduce fraud and increase accountability for expenses

It's apparent these objectives could easily be applied to the public sector accounting, and financial and compliance reporting environment. It's all about members of management, various committees, and the governing board, as well as the organization's auditor, acting with integrity and being accountable to their constituents as well as the general public. Now, let's delve deeper into some of the more significant provisions.

Corporate Governance

The Act requires:

- Audit committee members to be on the board and be independent (i.e., not part of management or compensated outside of board service)
- Audit committee to have (or to disclose why they don't have) at least one member who is a "financial expert" and who
 - Understands GAAP and financial statements
 - Can assess accounting principles
 - Has experience with preparing, auditing, and analyzing statements
 - Understands internal controls and audit committee functions
- Audit committee to be directly responsible for hiring, setting compensation, and overseeing auditor activities
- Auditor must report directly to audit committee
- Audit committee to approve non-audit services of audit firm

Governance is an especially relevant topic for public sector entities. The governing board, finance committee, and audit committee are often responsible for protecting the interests of a large number of constituency groups who could have very different views and opinions about how their interests are best addressed. While it is impossible to please all-of-the-people all-of-the-time, these constituents expect their interests to be addressed. We have learned in the external financial and compliance reporting area, that governance is best addressed through the creation and operation of a strong and independent audit committee.

To help build and strengthen audit committees, McGladrey & Pullen's National Public Sector Practice has published the *Audit Committee Guide for Not-for-Profit Organizations*. A printed version is available from your local McGladrey & Pullen, LLP office or an electronic version is available on our Web site at <http://www.mcgladrey.com/>.

Auditor Responsibilities

The Act requires:

- Lead and reviewing partner of audit firm to rotate every five years
- Auditor is prohibited from providing certain non-audit services
- Audit committee to pre-approve most non-audit services (i.e. tax preparation)
- All critical accounting policies and practices used by the company and management's application of them must be disclosed to the audit committee

The audit committee, or its equivalent for small NPOs, should be very involved in the audit arrangements and post audit review process. Both management and the audit committee should take great care in making any arrangements for the auditor to provide certain non-audit services. When an audit or attest engagement is performed in accordance with the Government Auditing Standards (GAS), issued by the Comptroller General of the United States, the auditor is currently restricted as to the type, as well as the manner in which many non-audit services are provided. We have designed a comprehensive guide to comply with the GAS and tools to avoid casting even the perception that our audit independence is impaired. While we have not seen proof that any benefits of a partner rotation requirement

is cost justified in the public sector audit environment, we have found that changes in staffing at various different levels, on a periodic basis, add value to the audit process.

Financial Statement Certification

Another requirement of the Act addresses the certification of financial statements by the chief executive and financial officers (CEO and CFO). These individuals face the threat of serving jail time for false certifications. Additionally, this section of the Act mandates that the CEO, CFO, controller and/or chief accounting officer cannot have worked for the auditing firm for one year preceding the audit.

As with the previous requirements, we can't take exception to the spirit behind these requirements. The CEO and CFO should understand enough about the financial, compliance and other external information reporting to sign such a certification or they should be required to gain such skills. For years, the audit profession has asked these individuals and other members of management to sign letters representing to the accuracy of audited financial statements; the Act just takes that responsibility a step farther. The employment requirement is designed to strengthen auditor independence and is similar to one of the provisions of the GAS independence standards.

Insider Trading and Conflict of Interest

These provisions prohibit loans to any directors or executives of the company.

The implications of this provision on NPOs should be minimal. NPOs are already subject to many conflict of interest provisions as a condition of retaining their favored federal tax status, as a result of state laws and regulations, or as a matter of internal policy. However, if your organization has not already done so, we suggest you adopt a formal policy prohibiting such transactions.

Because of the way the following Whistle-Blower Protection and Document Destruction provisions of the Act were written, it is generally held that they apply to all types of public sector entities, including not-for-profit organizations.

Whistle-Blower Protection

The Act calls for criminal penalties for any action taken in retaliation against whistleblowers. The Act also increases a whistleblowing employee's:

- Ability to sue an employer

- Ability to collect a civil remedy if discriminated against
- Ability to receive special damages and attorney's fees

Since this provision applies to not-for-profit organizations, we recommend you begin to take steps to protect your organization including:

- Identify weak spots
- Install processes to guard against fraud abuse
- Do not tolerate misconduct
- Develop procedures to handle employee complaints
- Take complaints seriously and handle them appropriately
- Establish a confidential and anonymous mechanism to encourage employees to report
- Make sure no punishment for reporting claims is allowed even if the claims are unfounded

A Sample Whistleblower Policy is available on the National Council of Nonprofit Associations (NCNA) Web site. [<http://www.ncna.org/>]

Document Destruction

Provisions of the Act make it a crime for a NPO to destroy, alter, cover up, or falsify (or to persuade someone else to do so), a document to prevent its use in an official proceeding.

NPOs should develop and follow a formal document retention and destruction policy. Maintain and archive all appropriate records about your operations (e.g., financial records, significant contracts, real estate and other major transactions, employment files, fundraising obligations, etc.). A Sample Document Destruction Policy is also available on the NCNA Web site.

Internal Control Disclosures

The Act's Section 404 requirements are turning out to be the most costly provisions for public companies to address. Internal control disclosures require that:

- Management establish and maintain an adequate internal control structure and procedures for financial reporting
- Management assess the effectiveness of the internal control structure
- Auditors attest to and report on the assessment made by management

Internal controls are the cornerstones for building, maintaining and improving stakeholder confidence, and these controls also provide a process to reasonably assure achievement in:

- Effectiveness and efficiency of operations
- Reliability of financial reporting
- Compliance with applicable laws, regulations and agreements
- Safeguarding assets

We clearly support the need for management to establish, maintain, and document significant financial and compliance controls for the public sector entity they represent. For many years, not-for-profit organizations subject to Single Audit have had more attention focused on their internal controls than most commercial entities, including certain public companies. However, we are concerned that management for many not-for-profit

organizations may not be adequately trained and are not prepared to assess their effectiveness. Further, we have learned from the commercial sector that the cost of the auditor attestation would be quite significant.

In Conclusion

We are not advocating that not-for-profit organizations adopt all of the provisions of the Sarbanes-Oxley Act. However, we feel that you cannot simply put your head in the sand and hope this issue just passes you by.

Before regulatory and oversight agencies make the decision for you, acquaint yourself with key provisions of the Act. Balance the needs and expectations of your constituents with any resource limitations you may have and try to achieve the best accountability improvement bang for the buck. We would be glad to help.

We all need to start working towards helping the industry regain the "good faith and trust" that the public has traditionally placed in not-for-profit organizations.