



The Sarbanes-Oxley Act of 2002
What does it mean for Not-for-Profit Organizations?

What is the sudden concern?

The Sarbanes-Oxley Act of 2002 (the Act), aimed at reforming the accounting profession and corporate ethical practices for publicly traded companies, was signed into law on July 30, 2002. This legislation, written as a reaction to recent Wall Street scandals, was designed to ensure adequate internal controls within publicly traded companies and to close loopholes that allowed corporate abuses to go unnoticed. It has caught the eye of state officials across the country who wish, using state legislative authority, to expand the protections that it affords investors of publicly traded companies to those doing business with smaller businesses and not-for-profit organizations.

New York Attorney General, Eliot Spitzer, is extremely vocal on this subject. He is using his position to address both corporate and not-for-profit fraudulent practices; currently, he is seeking legislation that would broaden the reach of the Act to smaller businesses and not-for-profit organizations. He cites the fact that not-for-profit organizations have "custody of billions of dollars in charitable funds," and that there is a need to protect charitable donors. Stating that meeting certain provisions of the Act would be difficult for smaller businesses and not-for-profit organizations, accounting and financial professionals have objected to Mr. Spitzer's proposed \$250,000 annual revenue threshold for applying its provisions. Mr. Spitzer is pushing for the proposal to be implemented over the next legislative cycle.

New York State's initiative may set the tone for similar legislative action around the country. As a result, it is important for not-for-profit organizations and their executive officers and boards to understand the Act and its possible implications.

Who does the Act currently affect?

As enacted, the law directly impacts the following groups:

- CPAs and CPA firms auditing public companies;
- Publicly traded companies, their employees, officers, board of directors and owners of more than 10 percent of the outstanding common shares;
- Attorneys who work for, or have as clients, publicly traded companies; and
- Brokers, dealers, investment bankers and financial analysts who work for publicly traded companies.

How does the law create oversight and how extensive is this oversight?

- The law establishes a five-member Public Company Accounting Oversight Board (the Board) that is subject to Securities and Exchange Commission (SEC) oversight.
- Duties of the Board include registering public accounting firms that prepare audit reports for publicly traded companies; and establishing or adopting auditing, quality control, ethics and independence standards.
- The Board has the authority to inspect, investigate and discipline public accounting firms and enforce compliance with the Act.
- The Board may investigate any act, omission or practice by a registered public accounting firm or an individual associated with a registered firm for any possible violation of the Act, the Board's rules, professional standards, or provisions of the securities laws relating to the preparation and issuance of audit reports for publicly traded companies.

How does the law affect services that CPAs can offer publicly traded audit clients?

- Most consulting is banned for publicly traded audit clients. These services are prohibited even if pre-approved by the company's audit committee and include:
 - Bookkeeping and related services,
 - Design and implementation of financial information systems,
 - Appraisal or valuation services including fairness opinions and contribution-in-kind reports,
 - Actuarial services,
 - Internal audit outsourcing,
 - Management functions or human resources,
 - Investment advisory or broker/ dealer services, and
 - Legal and "expert services unrelated to the audit."
- Audit Partner rotation is required every five years.
- CPA firms are required to report directly to the audit committee.
- A registered CPA firm is prohibited from auditing any SEC registered client whose Chief Executive Officer (CEO), Chief Financial Officer (CFO), controller or equivalent was on the audit team within the past year.

How does Sarbanes-Oxley affect publicly traded companies?

- The Act makes it unlawful for an officer or director or anyone acting for a principal to take any action to fraudulently influence, coerce, manipulate or mislead the auditing CPA firm.
- The SEC is mandated to issue rules requiring companies to disclose whether or not they have adopted a code of ethics for senior financial officers.
- The SEC is required to issue rules requiring a publicly traded company's audit committee to be comprised of at least one member who is a financial expert.
- The audit committee of a publicly traded company has responsibility for the appointment, compensation and oversight of any registered public accounting firm employed to perform audit services.
- Requires audit committee members to be members of the board of directors of the company, and otherwise be independent.
- CEOs and CFOs must certify, in every annual report, that they reviewed the report and that it does not contain untrue statements or omissions of material facts. If material noncompliance causes the company to restate its financials, the CEO and CFO forfeit any bonuses and other incentives received during the 12-month period following the first filing of the erroneous financials.
- CEOs and CFOs will be responsible for establishing and maintaining internal controls to ensure they are notified of material information.

How can the Sarbanes-Oxley Act potentially affect not-for-profit organizations?

The legislation raises the bar on corporate governance. As many not-for-profit organizations receive federal funding, the requirements imposed by the SEC under the auspices of the Act may be viewed as best practices by various federal agencies. By way of example, the Comptroller General of the United States is performing a study of auditor independence for the SEC. As the Comptroller General has general rule making authority over audits for recipients of federal funds, many commentators believe that these rules may cascade to the various federal agencies providing funding to not-for-profit organizations.

In addition, a specific section of the Act requires state regulators to make an independent determination of the proper standards applicable for those subject to their regulation. Ultimately, this may raise the bar for legal considerations involving executive officers and board members. If the provisions of the Act governing board conduct are seen as ordinary, reasonable and prudent practices (best practices), this may raise the standard of care imposed by the courts on executive officers and board members of not-for-profit organizations.

In light of the potential for legislation and other regulatory action there are many practical changes not-for-profits should be currently considering, for example:

- Assess the need for creating an audit committee and using it to address accounting policy and services provided by independent auditors.
- Consider requiring audit committee members be independent of the organizations they govern, and recruiting and/ or appointing a member who is a financial expert.
- The CEOs and CFOs of public companies are required to provide certification to publicly issued financial reports under the Act; there is an assumption that those officers providing the information and certifying the reports have an understanding of all material financial matters and related disclosures. Audit committees should assess whether or not their executive officers have this capability.
- Scrutinize transactions involving investment portfolios to make sure there is no conduct (for example favoritism afforded board members who are investment advisers or broker/ dealers) that could damage a not-for-profit organization's reputation.
- Study compensation arrangements with board members (for example legal services) to ensure that relationships between audit committee members and the organizations they govern are free of conflict.
- Study compensation arrangements with executive officers (for example interest free loans to officers) to ensure that transactions meet new IRS regulations. The issues brought to light by Sarbanes-Oxley in the compensation area is the subject of IRS Intermediate Sanction regulations, which require that a committee of the board of directors approves the total compensation package for executive officers annually.
- The Act requires an assessment of internal control over financial reporting. If you are a recipient of Federal funding you already have the requirement to have an established internal control structure, and all organizations should consider whether or not their internal control structures are sufficient to provide safeguards over the accuracy and veracity of financial reporting.
- The Internal Revenue Service is also considering changes to increase public confidence in the information provided by not-for-profit organizations in their tax returns. These proposed changes include disclosure of: the existence of conflicts of interest; whether the organization has an independent audit committee; any transactions or financial relationship with their substantial contributors, officers, directors, trustees and key employees.