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Sarbanes-Oxley Is Preventive Medicine For Not-For-Profits

By Mark Lilling

Government oversight of not-for-profit organizations may be just an audit failure away from being imposed. Congress enacted the Sarbanes-Oxley Act of 2002 in response to the widespread corporate fraud at public companies exemplified by Enron Corp.'s collapse and the closing of Arthur Andersen. The legislation was meant to enforce the concept that capital markets rely on the integrity of audited financial statements and the reputation and independence of auditors.

The integrity of not-for-profit financial statements is also important to the public. These statements do not affect earnings per share and stock prices, but contributors and members of organizations need to have confidence that funds are being spent for the intended purpose. On January 24, 2005, Eliot Spitzer, a New York State Attorney General, announced that the former president of the James Beard Foundation pleaded guilty to stealing foundation funds. Spitzer also filed a lawsuit in May 2004 against former New York Stock Exchange Chairman Richard Grasso seeking the return of some of Grasso's $187 million dollar pay package. "You can't pay the head of a non-for-profit that much money," Spitzer said.

Prudent organizations should be a step ahead of government regulators and implement relevant aspects of Sarbanes-Oxley. Not all of the requirements of Sarbanes-Oxley are relevant to non-for-profits, but the ideas of strong internal controls, independent board members and audit committees overseeing the financial reporting process are all good business practices.

Many not-for-profit organizations receive federal grants which require annual audits to be performed in accordance with government auditing standards, if federal funds exceed specified amounts. These standards require that the annual financial statements present additional auditor reports on federal awards, compliance with laws and reports on internal controls. Auditors are also held to higher standards in such situations, and the audit firm must be peer reviewed. Peer reviews are independent reviews of an audit firm's quality controls and policies and a test of engagements under standards established by the American Institute of Certified Public Accountants. Audit committee members should gain knowledge of these standards and evaluate the performance of auditors.

It is common for granting organizations to investigate the financial status of recipients to ascertain that their funds are being spent for the specified purpose – something which strong governance and internal controls can help ensure and document. Effective corporate governance also creates an atmosphere that attracts top management.

Not-for-profit organizations should consider adopting the following concepts of Sarbanes-Oxley:

Independent Board Members – Boards of directors should be comprised of independent members in order to establish strong effective

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governance and set a conservative tone. These directors should hire the executive director, set compensation, approve all other major transactions, grants and guide the overall direction of the organization.

Conflict Policies – Boards of directors should establish conflict of interest policies that ban specified transactions that involve insiders or nepotism. All transactions with related parties, if any should be reviewed and approved by the board.

Whistle Blower Hotlines – Whistle blower policies are important to the not-for-profit community. These procedures allow employees and related individuals to anonymously communicate potential abuses to the board.

Record Retention – Not-for profits should have formal document and record retention policies to ensure that all fundraising records and other documents are adequately maintained.

Audit Committees – This board sub-committee should consist of three or more directors, one of which is considered a "financial expert" and is responsible for overseeing the financial reporting process. This committee is responsible for understanding and approving all significant accounting policies, ensuring that the organization's internal controls and financial reporting process are adequate. Audit committee of larger entities should establish and monitor auditors.

Audit committees should also be responsible for the hiring, retention and compensation of independent auditors. Requiring auditors to report directly to the audit committee allows distance between management and audit oversight. Audit committee members should meet directly with the auditors, review all required communication and ensure that conservative accounting policies are in place.

Auditor Independence – Auditor independence has been strengthened by Sarbanes-Oxley's prohibition of non-audit services to public companies. These services may put the auditors in a position of evaluating their own work. These requirements restrict auditors from performing prohibited services to clients such as consulting, executive recruitment, valuations and internal auditing. Audit committees should evaluate all services performed by its auditors and specifically approve all non-audit services. Many audit committees are limiting non-audit services to tax compliance.

Not all Sarbanes-Oxley Act requirements make sense for non-for-profits, but it is clear that well-run organizations with strong independent boards, adequate internal controls and sound financial reporting are good business. Organizations should take the initiative and evaluate the advantages of adopting these policies before it is mandatory.

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