

Sarbanes-Oxley raises red flag for not-for-profits

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Background

Criminal fraud. CEO greed. Lax corporate governance. Questionable accounting practices. These were familiar phrases in the public discourse this year, accompanied by mounting outcry for congressional action. On July 30, 2002, Congress responded by signing into law the Sarbanes-Oxley Act of 2002, the most far-reaching accounting reform and corporate accountability legislation in decades. Sarbanes-Oxley subjects public companies in the United States to a host of new governance and other requirements.

Although not-for-profit organizations, including hospitals and healthcare systems, are not literally subject to Sarbanes-Oxley, they will soon feel its effects--especially of the governance provisions:

- * A number of states are currently considering emulating Sarbanes-Oxley provisions in legislation targeting not-for-profit organizations--especially states that have experienced notorious not-for-profit bankruptcies and other scandals;
- * Bond markets and state attorneys general are considering proposals to require similar governance provisions in order to regulate financing transactions and not-for-profit and charitable entity reporting;
- * Insurers have already started to penalize entities that don't comply with Sarbanes-Oxley provisions; and
- * Progressive managements and boards have already instituted many of these reforms as a type of "best-practice" standards for not-for-profit governance.

Effect on Not-for-Profit Organizations

The Sarbanes-Oxley governance provisions that are migrating to the not-for-profit arena are those dealing with the enhanced role of the board's audit committee, the certification of financial statements, compensation of senior executives, a CFO's code of conduct, and enhanced enforcement powers to remove unfit directors.

Role of the board's audit committee. Sarbanes-Oxley requires affected public corporations to create audit committees "directly responsible" for retaining

and supervising outside auditors. Audit-committee members must be independent, which means the CEO, CFO, and other management executives cannot be members. As part of the "independence" standard, committee members must not be paid for consulting or other services provided to the corporation outside of their service as directors. The corporation also must disclose whether the audit committee includes one or more members who are financial experts, and if not, why not. Finally, the committee must establish procedures for receiving whistle-blower complaints about the company's accounting practices.

Not-for-profit organizations can follow these audit-committee provisions voluntarily to avoid being perceived as more laxly governed than their for-profit peers. To this end, they would need to either create an audit committee where none existed or restructure the existing audit committee to remove senior management or directors with potential conflicts of interest. They also would need to make appropriate corresponding changes to the corporate bylaws and examine insurance coverage to ensure that committee members are protected.

Certification of financial statements. In a far-reaching provision going beyond the SEC's recently proposed rule on financial-statement certification, Sarbanes-Oxley requires that a public corporation's CEO and CFO certify in each annual report the following:

- * That they have reviewed the report;
- * That the report "does not contain any untrue statement of a material fact" or a material omission;
- * That the financial statements fairly present the financial condition of the corporation;
- * That the certifying individuals have designed and evaluated systems of internal controls to ensure that they are aware of material information concerning the corporation's operations; and
- * That the signers have disclosed to the company's auditors and audit committee all deficiencies in the controls and any fraud involving management or other key employees.

Full disclosure and, more importantly, implementation of procedures to ensure accurate reporting have become the "gold standard" against which all corporations will be measured. Although not-for-profit organizations are not yet required to meet the certification requirements under Sarbanes-Oxley, they would be wise to create effective internal controls to ensure accurate

reporting. Indeed, not-for-profit providers considering major transactions such as bond issuances, mergers, acquisitions, and affiliations should anticipate that underwriters, bond insurers, and opposing parties will insist on certification and related reporting requirements similar to Sarbanes-Oxley as part of the preclosing representations and warranties and postclosing obligations. Further, given the increased public scrutiny and regulation of accounting firms, not-for-profit providers may face increased disclosure and system certification representations to their auditors as part of the annual audit.

Compensation of senior executives. The new legislation also prohibits, with certain exceptions, personal loans from the corporation to "any director or executive officer." Existing loans are grandfathered. Although existing tax-exemption principles address the terms of such loans where the state not-for-profit code allows them (and not all states do), this provision goes further and prohibits them entirely. Senior-executive compensation packages involving such loans (such as a package developed to recruit a new CEO to an area with high housing costs) should be avoided because they are harder to justify in light of the new restrictions on the for-profit sector.

Code of conduct for CFOs. Sarbanes-Oxley also directs the SEC to promulgate rules requiring that corporations subject to the act disclose whether they have adopted a code of ethics for senior financial executives, and if not, why not. Like the certification provision, this provision will undoubtedly become the "gold standard." As a result, not-for-profit corporations that choose not to comply with the standard may be seen in a negative light by their constituencies, the media, their directors' and officers' liability insurers, and, possibly credit-rating agencies.

Power to remove unfit directors. Sarbanes-Oxley gives the SEC power to remove directors for "unfitness" (as opposed to the previous standard of "substantial unfitness"). In the past, states' attorneys general occasionally have sought the removal of certain directors of a not-for-profit corporation in proceedings brought to enforce charitable trusts. The Sarbanes-Oxley provision will influence them to scrutinize not-for-profit boards more closely and, thus, seek this remedy more frequently.

Conclusion

Boards of not-for-profit organizations should become familiar with the governance provisions of Sarbanes-Oxley and consider voluntarily complying with some or all of these provisions. It will not be long before they are forced to do so by the marketplace, regulators, insurers, or negative publicity directed at noncompliant not-for-profit organizations. Not-for-profit providers

that do not hold themselves to the same standard as their for-profit peers risk being perceived as having betrayed the trust of their communities.

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