



History and Legislative Background of the Sarbanes-Oxley Act of 2002 and State Nonprofit Accountability Legislation

On August 12, 2002, Senator Charles Grassley (R-Iowa) sent an angry letter to Marsha Johnson Evans, newly installed president of the American Red Cross, demanding an explanation for what was apparently false information contained in a response to an inquiry from his office about the Red Cross handling of the Liberty Fund monies that were collected to support September 11 victims' families. Subsequent to the Red Cross's initial response, Senator Grassley had received information that directly contradicted the Red Cross's assertions. [See Appendix A]

His letter to Ms. Evans continues:

Further, I was surprised by findings relating to a “surprise” audit of 27 Red Cross chapters that KPMG performed on September 18, 2001. In a memorandum to Dr. Healy and other high-ranking Red Cross officials including its Chief Financial Operator, Jack Campbell, KPMG identified problems at the chapters relating to how they processed and allocated donations received

since 9/11. KPMG's findings range from chapters mishandling "9/11" donations by keeping the money instead of transmitting the funds to the Liberty Disaster Relief Fund (Liberty Fund), to failing to follow national accounting procedures. For example:

- Alexandria, Virginia, "Chapter has not counted lockbox donations since 9/11, but assumes that most will be coded as local funds."
- Bergen Crossroads, NJ, "Due to this chapter's location, almost all funds were designated [World Trade Center]. For non-designated funds, coded as local."
- Los Angeles, California, "Chapter has no accurate accounting for funds received after 9/11, at least \$500,000 in total."
- Montgomery County, MD, "Amount collected prior to 9/11 unknown due to backlog in accounting reconciliations (recent transition in accounting department)."
- Pine Tree, ME, "Cash/checks unlocked at all times."
- Savannah, GA, "Chapter could not provide information regarding cash/checks collected."

Taken as a whole, these documents reveal a history of serious financial mismanagement by Red Cross chapters that I find troubling. However, I am more concerned that Red Cross senior management appears to take an attitude that bad news from local chapters is all best swept under the rug. The Red Cross' indifference to these major accountability problems was verbalized by Mr. Campbell during a CBS Evening News interview broadcast on July 30, 2002:

CBS News Correspondent Sharyl Attkisson: "Weren't you troubled by the results of the audits?"

Campbell: "Actually, we were not troubled by the results of the audits at all. There was no recognition of any kind of problem."

As surprising as this denial may be, it is consistent with other high-profile scandals in the private sector. Enron, WorldCom, and other corporate scandals may have led to the passage of Sarbanes-Oxley legislation, but clearly the private sector does not have the corner on duplicity. Nonprofit organizations including the American Red Cross, United Way of the National Capital Area, James Beard, and Boy Scouts of America have had very public scandals and have come under scrutiny by lawmakers at the federal and state levels.

WHAT IS THE SARBANES-OXLEY LEGISLATION ABOUT?

The Public Company Accounting Reform and Investor Protection Act was passed in 2002 in the wake of the Enron corporate scandal. The act is commonly referred to as the Sarbanes-Oxley Act (SOX), named after Senator Paul Sarbanes (D-MD) and Representative Michael Oxley (R-OH), who were its main sponsors. Although SOX was initially intended to raise the bar for integrity and competence for publicly traded companies—companies that have stockholders—its effect has been to promote greater accountability within both the nonprofit and the private sector.

The Sarbanes-Oxley Act is the latest in a long progression of regulatory reform aimed at rectifying corporate misdeeds. SOX has its roots in the Great Depression, which began in 1929 and lasted more than a decade, and was one of the deepest economic slumps to ever affect the United States, Europe, and other industrialized countries. Although the actual causes are still intensely debated, some factors believed to have contributed to the Great Depression in the United States were the mass stock speculation that occurred during the 1920s; a general imbalance of purchasing power and wealth in that a large percentage of the population was poor while a small percentage was very wealthy; the *laissez-faire* economic philosophy adhered to by Presidents Warren Harding (1920–1923), Calvin Coolidge (1923–1928), and Herbert Hoover (1929–1933); and the catastrophic crash of stock prices on the New York Stock Exchange (NYSE) in 1929. On October 29, 1929, known as Black Tuesday, the U.S. stock market crashed, and the value of stock steeply plummeted. Black Tuesday was one of the worst trading days in the history of the stock market. Stock prices collapsed and most of the financial gains of the previous year were wiped out within the first few hours of the market's opening. Since most Americans viewed the stock market as the chief indicator of the health of the economy, the 1929 crash destroyed public confidence in both the stock market and in the U.S. economy.

Stock value continued to fall for approximately three years, until late 1932. By that time, stocks had lost 80 percent of their value from 1929. Individual investors suffered devastating losses; overnight, large fortunes simply melted away. Many banks and other financial institutions, particularly those holding a large portion of stocks in their portfolios, also suffered

severe losses in assets. By 1933, 11,000 of the 25,000 banks in the nation had failed. In part, the 1929 crash was blamed on wildly inflated stock prices, poor monetary policies imposed by the Federal Reserve Board, fraud, concealed or misleading financial information, the rampant of buying of stock on margin, and inadequate controls on trading in the U.S. market. In 1932, the newly elected president, Franklin D. Roosevelt, and Congress sought to regulate the market by imposing controls on trading and requiring organizations that were offering securities for public sale to provide financial and other significant information about those securities.

Two important pieces of legislation emerged from this turbulent time. The Securities Act of 1933, which is frequently referred to as the truth in securities law, focused on assuring that investors are fully informed about the financial aspects of securities being offered for sale and on prohibiting deceit, misrepresentation, and other fraud in securities transactions. The Securities Exchange Act of 1934 created the Securities and Exchange Commission (SEC) and gave it the power to regulate many aspects of the securities industry. The act also provided the SEC with the authority to require periodic reporting of financial information by organizations that offered publicly traded securities and gave the SEC the power to register, regulate, and oversee brokerage firms, transfer agents, and the stock exchanges. Some of the important powers these two acts gave the SEC include:

- Regulate and register stock exchanges as well as all securities listed on an exchange.
- Regulate investment advisers and all dealers and brokers who are members of an organized exchange.
- Require that audited and current financial reports be filed.
- Set accounting standards.
- Prohibit all forms of stock price manipulation, such as insider trading.

The availability of properly audited and current financial reports enables investors to make informed and rational choices about whether to invest in a particular company. The audited financial reports are available from the organizations selling the securities in their stockholders' annual reports. The SEC continues to protect investors today, adding stability to investors' confidence and the markets in general. Additional controls on the market

after the 1987 crash regarding program trading and the institution of market shutdown mechanisms called circuit breakers helped to smooth out some of the volatility in the market.

Twenty-First-Century Corporate and Accounting Scandals

At the beginning of the twenty-first century, the U.S. market and its investors were stunned by a string of corporate and accounting scandals. For several years, the Enron Corporation, an energy company, participated in a number of partnership transactions that lost the organization a substantial amount of money. In 2001, Enron reported that it had failed to follow generally accepted accounting practices in its financial statements for 1997 through 2001 by excluding these unprofitable transactions. In these erroneous financial statements, the organization reported large profits when, in fact, it had lost a total of \$586 million during those years. Neither internal nor external controls detected the financial losses disguised as profits. The revelation of the erroneous financial reporting led to a collapse in the price of Enron stock, which fell from \$83 per share in December 2000 to less than \$1 per share in December 2001. However, some of Enron's managers made millions of dollars by selling their company stock before its price plummeted. Other investors, including Enron employees who had invested a large portion of their retirement portfolios in Enron stock, experienced substantial losses.

Role of Arthur Andersen LLP The CPA firm of Arthur Andersen LLP, which had been one of the largest accounting firms in the world, served as Enron's auditor throughout the years of erroneous statements. The firm allegedly "overlooked" Enron's questionable accounting practices because it was making a large amount of money providing Enron with consulting services and did not want to lose the consulting business. The firm was indicted by the U.S. Department of Justice, and in 2002, Arthur Andersen LLP was convicted of obstructing justice by shredding Enron-related documents requested by the SEC. Andersen's role in the Enron scandal is reflected in the SOX requirements to ensure auditor independence.

WorldCom In 2002, WorldCom, Inc., a prominent telecommunications company, admitted that it had failed to report more than \$7 billion in expenses over five quarterly periods. Its financial statements indicated that

WorldCom had been profitable over those quarters, when the company had actually lost \$1.2 billion. WorldCom's market worth plunged from \$200 billion to only \$10 billion in July. In July 2002, WorldCom filed for Chapter 11 bankruptcy, causing concerns among its investors, creditors, and telecommunication customers.

Enron and WorldCom were not the only companies that had questionable financial statements. Other corporate and accounting scandals included Tyco, Adelphia Communications, Xerox, and Global Crossing. These scandals understandably shook the public's confidence in the capital markets and in the integrity of corporate financial statements. In response to the lack of public confidence and the downward plummet in the stock market, the 107th Congress passed the Public Company Accounting Reform and Investor Protection Act, which was signed into law by President George W. Bush on July 30, 2002.

Importance of Sarbanes-Oxley Legislation

Many would agree that the SOX is the single most important piece of legislation affecting corporate governance, financial disclosure, and public accounting since the passage of the Securities Act of 1933 and the Securities Exchange Act of 1934. SOX contains sweeping reforms for issuers of publicly traded securities, auditors, corporate board members, and lawyers. It adopts new provisions intended to deter and punish corporate and accounting fraud and corruption, and provides stiff penalties for noncompliance. In essence, SOX seeks to protect the interest of shareholders and employees by improving the overall quality of financial reporting, independent audits, corporate accountability, and accounting services for public companies. As can be seen in Exhibit 1.1, SOX consists of 11 titles, with each title having multiple sections.

Several sections of the law address requirements and/or best practices for nonprofits and for private companies.

Title II

Title II of SOX details the rules to establish independence of the auditor from the company being audited. It defines which additional services the auditing firm may and may not provide, defines and prohibits conflicts of interest between auditors and the audited company, requires that the

audited firm rotates its auditors on a regular basis, and requires the auditing committee of the audited company to be responsible for the oversight of its auditors.

Titles III and IV

Titles III and IV of SOX detail the responsibilities and roles to be played by the audited company in regard to the audit and reports. For example, the principal executive and financial officers of the company are directly responsible to certify that the information in the annual or quarterly reports required by the SEC Act of 1934 is accurate, complete, and fairly presented. In addition, there are rules regarding insider trading and the professional responsibility for attorneys to report violations of securities law or breach of fiduciary duty. The titles also outline the disclosure requirements of relevant financial information, such as off-balance-sheet arrangements and relationships.

Titles VIII, IX, X, and XI

Titles VIII, IX, X, and XI outline the penalties for securities fraud and document destruction or alteration; create whistleblower protection for employee informants; and establish corporate responsibility for financial reports. Title IX provides that each periodic report containing financial statements filed with the SEC must be accompanied by a written statement by the issuer's chief executive officer and chief financial officer certifying that the report fully complies with the 1934 act and that information contained in the periodic report "fairly presents, in all material respects, the financial condition and results of operations of the issuer."

Relevance of SOX to Nonprofits

Currently, only a few of the provisions in SOX directly apply to nonprofit organizations. Nonprofits are required to adhere to provisions that provide protection to employees who report suspected fraud or other illegal activities and to provisions that address the destruction or falsification of records or documents.

The nonprofit sector has experienced its own recent scandals of perceived wrongdoing and fiscal mismanagement. For example, the United Way and the American Red Cross have received substantial unfavorable

**EXHIBIT I.1 SOX LISTING OF TITLES
AND SECTIONS**

Title	Section
I. Public Company Accounting Oversight Board	101: Establishment, administrative provision 102: Registration with the Board 103: Auditing, quality control, and independence standards and rules 104: Inspections of registered public accounting firms 105: Investigations and disciplinary proceedings 106: Foreign public accounting firms 107: Commission oversight of the Board 108: Accounting standards 109: Funding
II. Auditor Independence Best Practices for nonprofits come from this section.	201: Services outside the scope of practice of auditors 202: Preapproval requirements 203: Audit partner rotation 204: Auditor reports to audit committees 205: Conforming amendments 206: Conflicts of interest 207: Study of mandatory rotation of registered public accounting firms 208: Commission authority 209: Considerations by appropriate state regulatory authorities
III. Corporate Responsibility Best Practices for nonprofits come from this section.	301: Public company audit committees 302: Corporate responsibility for financial reports 303: Improper influence on conduct of audits 304: Forfeiture of certain bonuses and profits 305: Officer and director bars and penalties 306: Insider trades during pension fund blackout periods 307: Rules of professional responsibility for attorneys 308: Fair funds for investors
IV. Enhanced Financial Disclosures Best Practices for nonprofits come from this section.	401: Disclosures in periodic reports 402: Enhanced conflict-of-interest provisions 403: Disclosure of transactions involving management and principal stockholders 404: Management assessment of internal controls

Title	Section
	405: Exemption 406: Code of ethics for senior financial officers 407: Disclosure of audit committee financial expert 408: Enhanced review of periodic disclosures by issuers 409: Real-time issuer disclosures
VIII. Corporate and Criminal Fraud Accountability Document preservation Whistleblower protection Best Practices for nonprofits come from this section. Sections 802 and 806 (document preservation and whistleblower protection) are legal requirements for all organizations, including nonprofits.	801: Short title 802: Criminal penalties for altering documents 803: Debts nondischareable if incurred in violation of securities fraud laws 804: Statute of limitations for securities fraud 805: Review of federal sentencing guidelines for obstruction of justice and extensive criminal fraud 806: Protection for employees of publicly traded companies who provide evidence of fraud 807: Criminal penalties for defrauding shareholders of publicly traded companies
IX. White-Collar Crime Penalty Best Practices for nonprofits come from this section.	901: Short title 902: Attempts and conspiracies to commit criminal fraud offenses 903: Criminal penalties for mail and wire fraud 904: Criminal penalties for violations of the Employee Retirement Income Security Act of 1974 905: Amendment to sentencing guidelines relating to certain white-collar offenses 906: Corporate responsibility for financial reports
XI. Corporate Fraud and Accountability Best Practices for nonprofits come from this section. Section 1107 (retaliation against informants) is a legal requirement for all organizations, including nonprofits.	1101: Short title 1102: Tampering with a record or otherwise impeding an official proceeding 1103: Temporary freeze authority for the Securities and Exchange Commission 1104: Amendment to the Federal Sentencing Guidelines 1105: Authority of the Commission to prohibit persons from serving as officers or directors 1106: Increased criminal penalties under Securities Exchange Act of 1934 1107: Retaliation against informants

media coverage of their apparent failures in accountability and adherence to mission. Incidents such as these have cast the nonprofit sector in an unfavorable light and have damaged the public's trust in the integrity and the public benefit of nonprofits. Although the majority of the SOX provisions currently apply only to publicly traded corporations and not to nonprofit organizations, nonprofits could benefit operationally from adopting some of the SOX rules as best practices. In addition, voluntarily adhering to the SOX gold standards would create greater credibility and ability to recruit high-quality board members as well as attract the favorable attention of major donors, foundations, and other funding sources.

If the nonprofit sector wishes to retain its current level of relative self-regulation, nonprofit leaders need to make a visible effort to improve organizational governance and accountability. If this does not occur, nonprofits may come under additional unwanted government regulation. Some state attorneys general have already suggested that additional provisions of SOX should be applied to nonprofits. In order to avoid the imposition of external regulation, the nonprofit sector needs to show the government and the public that it can regulate nonprofit governance effectively.

CURRENT LEGISLATIVE ENVIRONMENT FOR NONPROFITS

U.S. Senate Finance Committee Hearings on Nonprofit Accountability, June 2004

Although the features of the Sarbanes-Oxley legislation may on the surface appear to have more impact on the private sector, the public sector (i.e. government) push for greater accountability includes the independent sector (i.e., the nonprofit world) as well. This section discusses the United States Senate Finance Committee June 22, 2004, hearings on Charitable Giving Problems and Best Practices, along with the highlights of recent California "Sarbanes-Oxley clone" legislation (SB1262) signed into law on September 29, 2004. The common theme of the testimony of witnesses, the congressional staff papers, and the California "Nonprofit Integrity Act" (SB1262) is that nonprofit organizations have, through fiscal and gover-

nance abuses, diminished public trust. Public outrage fueled these congressional hearings on nonprofit abuses.

Senate Finance Committee: Grassley “White Paper” Subsequent to the hearings and testimony, a staff discussion paper was released with recommendations for closer regulation of nonprofits. At the present time, these are simply a series of recommendations by congressional staff, but the tone and reach of the recommendations should be taken seriously by every nonprofit regardless of size.

The preface to the document instructs the reader that:

The document reflects proposals for reforms and best practices in the area of tax-exempt organizations based on staff investigations and research as well as proposals from practitioners, officers and directors of charities, academia and other interested parties. This document is a work-in-progress and is meant to encourage and foster additional comments and suggestions as the Finance Committee continues to consider possible legislation.¹

Some of the proposals in this document include:

Five-year review of tax-exempt status by the IRS. The White Paper recommends that:

On every fifth anniversary of the IRS’s determination of the tax-exempt status of an organization that is required to apply for such status, the organization would be required to file with the IRS such information as would enable the IRS to determine whether the organization continues to be organized and operated exclusively for an exempt purposes (i.e., whether the original determination letter should remain in effect). Information to be filed would include current articles of incorporation and by-laws, conflicts of interest policies, evidence of accreditation, management policies regarding best practices, a detailed narrative about the organization’s practices, and financial statements.

What would this mean for nonprofits? This recommendation would require nonprofits to submit documentation every five years that proves to the Internal Revenue Service that the organization continues to be in compliance with its 501(c)(3) designation. The following list of documents is particularly enlightening about the intent of this proposal.

- *Current articles of incorporation and by-laws.* The nonprofit would need to be clear about how its operations and governance continue to be in harmony with its founding documents
- *Conflict-of-interest policies.* The nonprofit would have to provide evidence of a conflict-of-interest policy and, most likely, proof that board members and senior management have completed annual affidavits identifying real or potential conflicts of interest.
- *Evidence of accreditation.* This document would be based on another recommendation, which is that nonprofits be required to obtain specific accreditation. (This recommendation is discussed later in this section.)
- *Management policies regarding best practices.* The nonprofit would be required to develop and submit written policies that demonstrate that the organization is implementing best practices in management and governance.
- *A detailed narrative about the organization's practices.* This document would require the nonprofit to provide a detailed explanation about what the organization does and why it is necessary/desirable in the community.
- *Financial statements.* These statements would be supplemental to the Form 990 that is required on an annual basis.

Form 990s—Proposals for Reform The White Paper recommends that nonprofits improve quality and scope of Form 990 and financial statements:

In a report to the Finance Committee, the General Accounting Office found significant problems in the accuracy and completeness of Form 990. Other studies, including by the General Accounting Office, have highlighted that there are no common standards for filing the Form 990, and thus similarly situated charities can have very different Form 990s. Because of the significant role played by the Form 990 in public and governmental oversight of tax-exempt organizations, some reforms are necessary to ensure accurate, complete, timely, consistent, and informative reporting by exempt organizations.

What does this mean for nonprofits? The Internal Revenue Service recognizes that there are no common standards for completion of Form 990s. The reform proposal seeks to identify reforms that will introduce a standardized way to submit Form 990s.

Form 990s would require signature by chief executive officer.

Require that the chief executive officer (or equivalent officer) of a tax-exempt organization sign a declaration under penalties of perjury that the chief executive officer has put in place processes and procedures to ensure that the organization's Federal information return and tax return (including Form 990T) complies with the Internal Revenue Code and that the CEO was provided reasonable assurance of the accuracy and completeness of all material aspects of the return. This declaration would be part of the information for tax returns.

What does this mean for nonprofits? This proposal would require a nonprofit CEO to sign an affidavit that "under penalties of perjury . . ." the organization's Form 990 complies with the Internal Revenue Code and the CEO is providing assurance of the accuracy and completeness of all material aspects of the return. (The financials accurately reflect the financial position of the nonprofit.) This affidavit would be part of the information or tax return.

Based on recent events in the nonprofit world, if this proposal was law, some very high-profile nonprofit executives would be going to jail. The recommendation here is clearly that nonprofit executives and board members should be held to the same criminal liability standards as those of their private sector counterparts.

Penalties for failure to file complete and accurate form 990.

The present law penalty for failure to file or to include required information is \$20/day up to the lesser of \$10,000 or 5 percent of gross receipts per return (increased to \$100/day up to \$50,000 per return for organizations with gross receipts over \$1 million in a year). Under the proposal, the penalty for failure to file would be doubled and for organizations with gross receipts over \$2 million per year, the present law penalty would be tripled. Failure to file a required 990 for two consecutive years (or for three of four years) could result in loss of tax exemption, or other penalties such as loss of status as an organization to which deductible contributions may be made.

What does this mean for nonprofits? There will be severe penalties for failing to file a Form 990. The proposals recommend loss of tax exemption, or loss of status as an organization to which deductible contributions may be made. For a nonprofit, this means the organization can no longer tell

donors that their contributions are tax-exempt. In other words, the “non-profit” is out of business.

Required disclosure of performance goals, activities, and expenses in Form 990 and in financial statements. Charitable organizations with over \$250,000 in gross receipts would be required to include in the Form 990 a detailed description of the organization’s annual performance goals and measurements for meeting those goals (to be established by the board of directors) for the past year and goals for the coming year. The purpose of this requirement would be to assist donors to better determine an organization’s accomplishments and goals in deciding whether to donate, and not as a point of review by the IRS. Charitable organizations would be required to disclose material changes in activities, operations, or structure. Charitable organizations would be required to accurately report the charity’s expenses, including any joint cost allocations, in their financial statements and Form 990s. Exempt organizations would be required to report how often the board of directors met and how often the board met, without the CEO (or equivalent) present.

What does this mean for nonprofits? Transparency is the predominant theme of these recommendations. The congressional staff may have been spurred on by the volume of public complaints about nonprofit organizations that, for every donor dollar, contribute very little to programs. In recent years, the media has conducted many investigations of bogus charities, and certainly some charities that are household names have also abused donor trust by misdirecting donations to exorbitant salaries, expenses, and other abuses. Note that these disclosures are required to be presented on Form 990. The accuracy of these disclosures could carry criminal liability if the other proposal on CEO signatures is enacted into law.

Nonprofits Would Be Required to Make Certain Documents Publicly Available Public oversight is critical to ensuring that an exempt organization continues to operate in accordance with its tax-exempt status. For charitable organizations, public oversight provides donors with vital information for determining which organizations have the programs and practices that will ensure that contributions will be spent as intended. Oversight is facilitated under present law by mandated public disclosure

of information returns and applications for tax-exempt status, but more can be done.

Disclosure of financial statements.

Exempt organizations would be required to disclose to the public the organization's financial statements.

Web site disclosure.

Exempt organizations with a Web site would be required to post on such site any return that is required to be made public by present law, the organization's application for tax exemption, the organization's determination letter from the IRS, and the organization's financial statements for the five most recent years.

What does this mean for nonprofits? Although the text recognizes that there are current public oversight opportunities, the authors comment that the nonprofit world could be doing more to provide transparency. The recommendations are, again, aimed at ensuring that the public has access to information that would be vital to their making a decision to make a donation. Of particular note is the recommendation that the nonprofit's Web site be employed to present not only those documents currently required (Form 990) but also the organization's:

- Application for tax exemption
- Determination letter from the IRS
- Financial statements from the five most recent years

Proposals Regarding Nonprofit Boards

The White Paper makes these recommendations:

Board duties. The duties of a board that are described in this document would also be the duties of a trustee for a charitable trust. A charitable organization shall be managed by its board of directors or trustees (in the case of a charitable trust). In performing duties, a board member has to perform his or her duties in good faith; with the care an ordinarily prudent person in a like position would exercise under similar circumstances; and in a manner the director reasonably believes to be in the best interests of the mission, goals, and purposes of the corporation. An individual who has special skills or expertise has a duty to use such skills or expertise. Federal liability for breach of

these duties would be established. Any compensation consultant to the charity must be hired by and report to the board, and must be independent. Compensation for all management positions must be approved annually and in advance unless there is no change in compensation other than an inflation adjustment. Compensation arrangements must be explained and justified and publicly disclosed (with such explanation) in a manner that can be understood by an individual with a basic business background.

The board must establish basic organizational and management policies and procedures of organization and review any proposed deviations. The board must establish, review, and approve program objectives and performance measures and, review and approve significant transactions. The board must review and approve the auditing and accounting principles and practices used in preparing the organization's financial statements and must retain and replace the organization's independent auditor. An independent auditor must be hired by the board, and each such auditor may be retained only five years. The board must review and approve the organization's budget and financial objectives as well as significant investments, joint ventures, and business transactions. The board must oversee the conduct of the corporation's business and evaluate whether the business is being properly managed.

The board must establish a conflict-of-interest policy (which would be required to be disclosed with Form 990) and require a summary of conflicts determinations made during the 990 reporting year. The board must establish and oversee a compliance program to address regulatory and liability concerns.

The board must establish procedures to address complaints and prevent retaliation against whistleblowers. All of these requirements must be confirmed on Form 990. Relaxation of certain of these rules might be appropriate for smaller tax-exempt organizations.

Board composition. The board shall be comprised of no less than 3 members and no greater than 15.

What does this mean for the nonprofits? The proposals for reform indicate that the traditional legal standards of care, loyalty, and obedience could be incorporated into a law governing board member behavior. The proposal clearly indicates that the board is regarded as the final authority in the management of the nonprofit organization and, as such, will be held accountable for the implementation of such policies as a conflict-of-interest policy and whistleblower protection. Board size appears to be capped at 15, but the authors did not present clear reasons for this limitation.

The entire board could now be held directly accountable for the executive director's compensation package. Many nonprofit boards do not have access to the compensation package of the executive director, as this has come under the exclusive purview of the board's executive committee.

Proposals for Government Encouragement of Best Practices

Accreditation. The White Paper recommends:

There would be an authorization of \$10 million to the IRS to support accreditation of charities nationwide, in states, as well as accreditation of charities of particular classes (e.g., private foundations, land conservation groups, etc.). The IRS would have the authority to contract with tax-exempt organizations that would create and manage an accreditation program to establish best practices and give accreditation to members that meet best practices and review organizations on an ongoing basis for compliance. The IRS would have the authority to base charitable status or authority of a charity to accept charitable donations on whether an organization is accredited.

What does this mean for nonprofits? This proposal seeks to empower the Internal Revenue Service with the authority to require accreditation of nonprofits as a requisite to accepting charitable donations. The authors are seeking to empower the IRS to add another layer of compliance to the Form 990 proposals and five-year reauthorization of nonprofits.

Oversight provisions. The White Paper recommends that:

The Federal Government establish an Exempt Organization Hotline for reporting abuses by charities and complaints by donors and beneficiaries. Information sharing with State Attorneys General, the Federal Trade Commission, and the U.S. Postal Service for enforcement purposes, including referrals by the IRS and an annual report to Congress by the General Accounting Office of the results of such referrals.

This proposal would establish a hotline for anyone anywhere to file complaints about nonprofits and/or report abuses. Whether this is an anonymous hotline remains to be seen, but the authors appear to want to collect this information at a national level. How the complaints and claims would be investigated and by what agency also remains to be seen.

CALIFORNIA'S NONPROFIT INTEGRITY ACT

Provisions That Apply to Nonprofits with Revenues in Excess of \$2 Million

The state of California passed a Nonprofit Integrity Act (SB1282), which imposes many of the features of Sarbanes-Oxley legislation on nonprofits with revenues in excess of \$2 million operating in that state.

Some of the key provisions of this law include:

- Nonprofits will be required to have an annual audit performed by a CPA who is “independent” as defined by U.S. Government auditing standards. The results of the audit will need to be made available to the public and the attorney general.
- Nonprofits will be required to have an audit committee whose membership cannot include staff and must not overlap more than 50 percent with the finance committee; the audit committee can include members who are not on the organization’s board of directors.

What does this mean for nonprofits in California? To ensure greater accountability in executive compensation the law requires that the board approve the compensation, including benefits, of the corporation’s president or CEO and its treasurer or CFO for the purposes of assuring that these executives’ compensation package is reasonable.

What does this mean for nonprofits in California? Requires disclosure of written contracts between commercial fundraisers and nonprofits and available for review on demand from the attorney general’s office. Fundraisers must be registered with the attorney general’s office.

These points in the law apply to all nonprofits, regardless of revenue size, in California.

- Nonprofits must make their audits available to the public on the same basis as their IRS Form 990 if they prepare financial statements that are audited by a CPA.
- Except for emergencies, notice of a solicitation campaign by a “commercial fundraiser for charitable purposes” must be filed at least 10 days before the commencement of the solicitation campaign, events,

or other services. Each contract must be signed by an official of the nonprofit, and include the contract provisions specified in the law.

- Regarding fundraising activities, the law states that a nonprofit must not misrepresent or mislead anyone about its purpose, or the nature, purpose, or beneficiary of a solicitation. Further, the law specifies that there be specific disclosures in any solicitation that the funds raised will be used for the charitable purpose as expressed in articles of incorporation or other governing documents. The nonprofit is expected to ensure that fundraising activities are adequately supervised to ensure that contracts and agreements are in order and that fundraising is conducted without intimidation or undue influence.

What does this mean for nonprofits in California? Nonprofits in California, regardless of their size, need to review their fundraising practices, particularly if some or all of their fundraising is outsourced to commercial fundraising firms. Nonprofits will be liable for abuses by vendors of fundraising services. As a practical matter, boards should insist that due diligence activities be conducted before contracting with any vendor, particularly those providing fundraising services. The California law, however, places strict parameters around third-party fundraising.

SUMMARY

Corporate and nonprofit malfeasance is, sadly, not a new development. The Sarbanes-Oxley Act and California's Nonprofit Integrity Act are intended to obligate nonprofit boards and senior management to conduct the business of the nonprofit in a more transparent and accountable fashion.

Whistleblower protection and document preservation policies are the two requirements for nonprofits from the Sarbanes-Oxley legislation. The legislation, however, puts forward a series of best practices that are rapidly becoming instituted as the new platinum standard in nonprofit management.

ENDNOTE

1. Senate Finance Committee White Paper, 2004, p. 1.

