



Overview of the Legislation and Its Implications for Nonprofits

The scene is an elegant Minneapolis restaurant. Five career women are having lunch together. Lois is the CFO of a well-known nonprofit in the Twin Cities. Shelly is an attorney with a prominent law firm. Peg is an author and consultant. Toni is a professor, author, and consultant. Virginia is a community volunteer who sits on a number of prestigious nonprofit boards. She is also the Chair of the Board of a historic Minneapolis landmark. The women met for lunch that day because they were colleagues on a *pro bono* project. Peg attempted, once again, to convince Virginia that the conflict of interest presented by a staff member was indeed a serious issue, and the discussion turned to Sarbanes-Oxley. Virginia emphatically stated, “Sarbanes-Oxley has *nothing* to do with nonprofits! You don’t know what you are talking about!” Both Peg and Toni attempted in vain to dissuade Virginia of this notion.

Yes, Virginia, Sarbanes-Oxley does apply to nonprofits!

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, its effect has been to promote greater accountability within both the nonprofit and private sector. Along with public companies such as Enron, the nonprofit world has seen high-profile scandals such as those involving the United Way and the American Red Cross. Subsequent to these nonprofit scandals, legislatures in both New York and California have begun deliberations on SOX “clones,” targeting nonprofit accountability. In a similar vein, the U.S. Senate Finance Committee conducted hearings in June 2004 and published some proposed actions to raise the bar for nonprofit accountability. These proposals include:

- Require nonprofits to have their Internal Revenue Service (IRS) tax exempt status reviewed every five years, with extra documents and a new processing fee
- Increase information disclosures on IRS Form 990, including annual performance goals and measurements for meeting those goals
- Require Form 990 to be signed by an organization’s chief executive officer (CEO) or equivalent under penalties or perjury
- Create penalties for failure to file a complete and accurate 990
- Appropriate \$10 million for various forms of nonprofit accreditation
- Establish an Exempt Organization Hotline for reporting abuses by charities and complaints by donors and beneficiaries
- Limit board size to 15 members

The tone of the preceding proposals should be unmistakable. Public pressure is mounting to have nonprofits come under a higher level of scrutiny and regulation. Although only two provisions of SOX apply to both nonprofit and publicly traded companies (whistleblower protection and document preservation), visible compliance with SOX standards establishes a “platinum standard” and a marketing competitive advantage that can provide benefits to any nonprofit. Best practices that emerge from SOX compliance include:

- A more effective board whose members understand and adhere to their fiduciary obligations and recognize their responsibility in governing the nonprofit
- Higher level of management and staff accountability
- Effective protocols to ensure that the nonprofit remains in compliance with SOX and nonprofit “industry standards” and addresses future standards
- Better competitive positioning by making known that the nonprofit adheres to the SOX platinum standard in its operating practices
- Greater credibility and ability to recruit high-quality board members and to attract the favorable attention of major donors, foundations, and other funding sources

SOX is the latest in a long progression of regulatory reform aimed at rectifying corporate misdeeds. A brief look at a segment of this country’s economic history addresses the following questions:

- What events brought about legislation that addresses corporate misdeeds?
- What areas of business and nonprofit operations are facing more scrutiny and why?
- What are the features of SOX and what are the best practices that emerge from this law?
- Why have these best practices raised the bar for nonprofits?

Sox Has Its Roots in the Great Depression

The Great Depression, which began in 1929 and lasted more than a decade, was one of the deepest economic slumps to affect the United States, Europe, and other industrialized countries. Although the actual causes of the Great Depression are still intensely debated, some of the factors believed to contribute 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 with the decline in stock value. Many banks and other financial institutions, particularly those holding a large portion of stocks in their portfolios, also suffered severe losses in assets and by 1933, 11,000 of the 25,000 banks in the United States had failed. By 1932, the U.S. manufacturing output had declined to only 54 percent of its 1929 level, and unemployment had increased to between 12 and 15 million workers, approximately 25–30 percent of the labor force.

Truth in Securities Law

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 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 the securities being offered. Two significant pieces of legislation were passed, one in 1933 and the second in 1934. The Securities Act of 1933, which is frequently referred to as the “truth in securities” law, has two basic aims, to:

- Assure that investors are fully informed about the financial aspects of securities being offered for sale
- Prohibit deceit, misrepresentations, 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
- Register 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 with the SEC
- 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 its stockholders' annual reports. Most are also easily accessible from the SEC, through EDGAR, the online Electronic Data Gathering, Analysis, and Retrieval system (www.sec.gov/edgar.shtml). EDGAR collects, validates, indexes, and disseminates the reports from companies that are required to file reports with the SEC.

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. After the 1987 crash, the U.S. stock market appeared to be well regulated and well functioning.

Twenty-First 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. The price of Enron stock 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 experienced substantial losses, including Enron employees who had invested a large portion of their retirement portfolios in Enron stock.

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 since it was making a large amount of money for 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 for shredding Enron-related documents requested by the SEC.

The WorldCom Debacle 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 SOX

Many would agree that 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.

Title I

Title I of SOX created a Public Company Accounting Oversight Board (PCAOB) that has extensive authority to regulate the auditors and audits of publicly held companies. The PCAOB is a nonprofit organization with strong ties to the SEC. Partial funding for the PCAOB comes from the SEC, the SEC has the power to appoint the PCAOB's chairperson and members, and the SEC must approve all rules and standards established by the PCAOB. Only accounting firms that have been accepted for registration with the PCAOB will be allowed to prepare or audit reports for companies registered with the SEC. Approval for registration with the PCAOB is based on a detailed application that requires the accounting firm to provide information regarding its audit clients, internal quality control policies and procedures, accounting personnel, licensure, and financial standing. In addition, approved firms must agree to undergo periodic inspections and

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: Pre-approval 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

Title	Section
	404: Management assessment of internal controls 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
V. Analyst Conflicts of Interest	501: Treatment of security analysts by registered securities associations and national security exchanges
VI. Commission Resources and Authority	601: Authorization of appropriations 602: Appearance and practice before the Commission 603: Federal court authority to impose penny stock bars 604: Qualifications of associated persons of brokers and dealers
VII. Studies and Reports	701: GAO study and report regarding consolidation of public accounting firms 702: Commission study and report regarding credit rating agencies 703: Study and report on violators and violations 704: Study of enforcement actions 705: Study of investment banks
VIII. Corporate and Criminal Fraud Accountability Document preservation Whistleblower protection	801: Short title 802: Criminal penalties for altering documents 803: Debts nondischargeable if incurred in violation of securities fraud laws 804: Statue 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

Best Practices for nonprofits come from this section AND Sections 802 and 806 (Document preservation and Whistleblower protection) are legal requirements for ALL organizations, including nonprofits

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EXHIBIT 1.1 SOX LISTING OF TITLES AND SECTIONS (CONTINUED)

Title	Section
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
X. Corporate Tax Returns	1001: Sense of the Senate regarding the signing of corporate tax returns by chief executive officers
XI. Corporate Fraud and Accountability Best Practices for nonprofits come from this section, AND 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

provide annual reports to the PCAOB. Additional funding for the PCAOB will come from fees paid by the registered accounting firms.

The PCAOB has the authority to establish standards and rules regarding the content of audits, the accounting firm’s internal quality control policies and procedures, and the length of time that documents related to an audit must be retained. While the PCAOB does not have the direct power to set accounting standards, a separate accounting standards organization will develop the standards that the PCAOB will use.

Nonprofits currently don't have a government-sponsored watchdog like the PCAOB, and the PCAOB currently has no authority over nonprofit organizations. The word *currently* is an important word in the previous sentence. Public and governmental policymakers have a growing concern about the performance and integrity. As discussed earlier, some states are already discussing SOX-like legislation that would cover nonprofits. The nonprofit industry just may end up with a watchdog similar to the PCAOB.

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 rotate its auditors on a regular basis, and requires the auditing committee of the audited company to be responsible for the oversight of its auditors. We discuss how this title can be used to help a nonprofit develop a SOX-like operating standard in Chapter 2.

Titles III and IV

Titles III and IV of SOX detail the responsibilities and roles the audited company plays in regard to the audit and reports. For example, the principal executive and financial officers of the company are directly responsible for certifying 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. How these titles can be used to help a nonprofit develop a SOX-like operating standard is the topic of Chapters 2, 3, and 4.

Titles V, VI, and VII

Titles V, VI, and VII primarily provide details regarding security analysts, appropriations, and various studies and reports performed by the GAO and others. While these titles are important in terms of establishing and

implementing SOX, they are not directly relevant to the “best practices” that can be gleaned from the legislation. These titles will thus not be discussed in any detail.

Titles VIII, IX, X, and XI

Titles VIII, IX, X, and XI outline the penalties for securities fraud, 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 CEO and CFO 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.” How these titles can be used to help a nonprofit develop a SOX-like operating standard is presented in Chapters 3, 4, and 5.

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 Title III, Section 806, and Title XI, Section 1107, which provide protection to employees who report suspected fraud or other illegal activities. In addition, Title VIII, Section 802, and Title XI, Section 1102, which address the destruction or falsification of records or documents, apply to nonprofits.

The nonprofit sector has recently 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 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. While it is true that the majority of the SOX provisions currently only apply 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 attracting the favorable attention of major donors, foundations, and other funding sources.

If the nonprofit sector wants to obtain 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 regulation by the government. Some state attorneys general have already suggested that additional provisions of SOX should be applied to nonprofits. The nonprofit sector needs to show the government and the public that it can effectively regulate nonprofit governance to avoid the imposition of external regulation.

In the remaining chapters of this book, we focus on the provisions of SOX that directly apply to nonprofit organizations, and those provisions that could serve as “best practices” for the nonprofit sector.

CURRENT LEGISLATIVE ENVIRONMENT FOR NONPROFITS

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

Although the features of the SOX 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 recent 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 governance abuses, diminished public trust. Public outrage fueled these Congressional hearings on nonprofit abuses. Further reports of financial and governance mismanagement appear on an almost daily basis—sometimes even in the “Food” section of the newspaper.¹

Internal Revenue Service Commissioner’s Testimony As part of the Senate Finance Committee’s June 2004 hearings on nonprofit accountability, Mark W. Everson, the commissioner of the IRS, provided some very sobering testimony on that agency’s plans for oversight and enforcement of the nonprofit sector. The following excerpts of Mr. Everson’s

testimony should leave no doubt about the IRS' short-term agenda for bringing about nonprofit accountability.

We can be proud of the vast majority of exempt organizations that are fully and effectively carrying out their important missions. I must emphasize that my remarks, which by necessity will focus on problems we have observed, should not be interpreted as an indictment of the tax-exempt sector. The vast majority of tax-exempt entities carry out their valuable role in full compliance with the letter and spirit of the laws. As you know, the Administration strongly supports efforts to encourage and support donations to our Nation's charities. The Administration's FY 2005 Budget includes a number of tax relief proposals designed to stimulate charitable giving. However, I share your concern that some entities are using their status to achieve ends that Congress clearly did not intend when it conferred the privilege of tax-exemption.

Before I begin, let me give you a few statistics on the population I am here to discuss. When the subject of tax-exempt organizations arises, we commonly think of charities. This is understandable, given the prominent and valuable role of charitable organizations. But the tax-exempt sector is far broader. The approximately 3,000,000 tax-exempt entities include almost 1,000,000 section 501(c)(3) charities and almost 1,000,000 employee plans . . . This sector is a vital part of our nation's economy that employs about one in every four workers in the U.S. In addition, nearly one-fifth of the total U.S. securities market is held by employee plans alone. As I will discuss, there are abuses of charities that principally rely on the tax advantages conferred by the deductibility of contributions to those organizations.

If these abuses are left unchecked, I believe there is the risk that Americans not only will lose faith in and reduce support for charitable organizations, but that the integrity of our tax system also will be compromised. I am committed to combating abuse in this area. We recently released our IRS Strategic Plan for 2005-2009. Along with improving service and modernizing our computer systems, one of our strategic goals is to enhance enforcement of the tax law . . . Historically, IRS functions regulating tax-exempt entities have not been well funded due to the lack of revenue they generated. This view is misdirected in light of the size and importance of the sector. With staffing in this area flat at best and with the number of charities increasing annually, our audit coverage has fallen to historically low levels, compromising our ability to maintain an effective enforcement presence in the exempt organizations community. One of our four specific objectives is to deter abuse within tax-exempt and governmental entities,

and misuse of these entities by third parties for tax avoidance or other unintended purposes . . .

The Administration's FY 2005 Budget contains a number of legislative proposals, originally announced by the Treasury Department in March 2002 to combat abusive transactions. These proposals include statutory changes that would create better, coordinated disclosure of abusive transactions . . . although the Administration is committed to encouraging gifts to charity, it also wants to ensure that taxpayers are accurately valuing property they donate to charity . . .

[*Governance*] In recent years there have been a number of very prominent and damaging scandals involving corporate governance of publicly traded organizations. The Sarbanes-Oxley Act has addressed major concerns about the interrelationships between a corporation, its executives, its accountants and auditors, and its legal counsel. Although Sarbanes-Oxley was not enacted to address issues in tax-exempt organizations, these entities have not been immune from leadership failures. We need go no further than our daily newspapers to learn that some charities and private foundations have their own governance problems. Specifically, we have seen business contracts with related parties, unreasonably high executive compensation, and loans to executives. We at the IRS also have seen an apparent increase in the use of tax-exempt organizations as parties to abusive transactions. All these reflect potential issues of ethics, internal oversight, and conflicts of interest . . .

[*Using credit counseling nonprofits as an example*] We are focusing our audit resources on those organizations with the highest risk of noncompliance with tax law. We have selected 50 tax-exempt credit counseling organizations for examination; the majority of these examinations are currently underway. The balance will be assigned to agents by the end of this fiscal year. To date, we have initiated and will be pursuing the use of proposed revocations of exemption of credit counseling organizations in appropriate circumstances. We also plan to seek injunctions and penalties against both individuals and companies for promoting fraudulent tax schemes.

[*Regarding Excessive Executive Compensation*] [We] will use all tools available to ensure that these organizations act lawfully, including revoking tax-exempt status where warranted. Compensation Issues: The issues of governance and executive compensation are closely intertwined. We are concerned that the governing boards of tax-exempt organizations are not, in all cases, exercising sufficient diligence as they set compensation for the leadership of the organizations. There have been numerous recent reports of executives of both private foundations and public charities who are receiving

unreasonably large compensation packages. Neither a public charity nor a private foundation can provide more than reasonable compensation . . . In general, reasonable compensation is measured with reference to the amount that would ordinarily be paid for comparable services by comparable enterprises under comparable circumstances . . .

Section 501(c)(3) provides that the assets of an organization cannot inure to the benefit of private shareholders or individuals. If an organization pays or distributes assets to insiders in excess of the fair market value of the services rendered, the organization can lose its tax exempt status . . . This summer (2004), we are launching a comprehensive enforcement project to explore the seemingly high compensation paid to individuals associated with some exempt organizations. This is an aggressive program that will include both traditional examinations and correspondence compliance checks . . . These organizations need to know that their decisions will be reviewed by regulatory authorities . . . Organizations also will be asked for details concerning the independence of the governing body that approved the compensation and details of the duties and responsibilities of these managers with respect to the organization. Other stages will follow, and will include looking at various kinds of insider transactions, such as loans or sales to executives and officers.

[*Form 990*] We also will be looking at organizations that failed to, or did not fully complete, compensation information on Form 990. This information will help inform the IRS about current practices of self-governance, both best practices and compliance gaps, and will help us focus our examination program to address specific problem areas.

[*Coordination with Other Federal Agencies*] We work with other federal agencies in a number of areas. For example, we continue to engage in information sharing with the FTC to learn more about the credit counseling industry . . . We expect to continue this mutually beneficial relationship and find other ways to leverage our scarce resources.

[*Enhancing Governance—The Need for More Outreach*] As I discussed above, stronger governance procedures are needed for exempt organizations. The sanctions for serious lapses in governance are clear. There is the possibility of revocation of exemption, along with the various excise taxes against individuals that I mentioned before. But sanctions are a last resort . . . organizations without effective governance controls are more likely to have compliance problems . . . [The IRS will] require disclosure of whether the organization has a conflict of interest policy or an independent audit committee, and whether additional disclosure should be required concerning certain financial transactions or insider relationships . . . Our Form 990 revi-

sion team is working on a comprehensive overhaul of the form to provide better compliance information about these organizations to the IRS, the states, and the public . . .

[*Vehicle Donations*] For a taxpayer, donating a car to a charity has definite appeal. One can help a charitable cause, dispose of the car, and take advantage of tax provisions that are designed to support the generosity of Americans. Deductions are limited to the fair market value of the property. In its recent study, the GAO estimated that about 4,300 charities have vehicle donation programs. In its review of returns for tax year 2000, the GAO estimated that about 733,000 taxpayers claimed deductions for donated vehicles they valued at \$500 or more. Highly troubling is GAO's analysis of 54 specific donations, where it appears that the charity actually received less than 10% of the value claimed on the donor's return in more than half the cases, and actually lost money on some vehicles . . . we cannot ignore the clear implications of the study . . . We are educating donors and charities on what constitutes a well-run donation program . . . We will be partnering with the states to distribute the brochures to the fundraising community, as the states regulate fundraising activity.²

Staff Discussion Paper—Senate Finance Committee Subsequent to the hearings and testimony, a staff discussion paper was released with recommendations for closer regulation of nonprofits. Currently, 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." (Senate Finance Committee Staff Discussion Draft, p. 1, 2004.)

Some of the proposals in this document include:

Five-year review of tax-exempt status by the IRS. The staff discussion draft recommends that:

On every fifth anniversary of the IRS' 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 IRS that the organization continues to comply with its 501(c)(3) designation.

The list of documents specified here are 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 continues to be in harmony with its founding documents.
- *Conflicts 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 financial statements would be supplemental to the Form 990 that is required on an annual basis.

Form 990s—Proposals for Reform The staff discussion draft recommends that:

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, included by the General Accounting Office, have highlighted that there are no common standards for filing Form 990 and thus similarly situated charities can have very different Form 990s. Because of the significant role played by 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 IRS recognizes that there are no common standards for completion of Form 990. The reform proposal seeks to identify reforms that will introduce a standardized way to submit Form 990s.

Form 990s would require signature by CEO. Require that the CEO (or equivalent officer) of a tax-exempt organization sign a declaration under penalties of perjury that the CEO 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 or tax return.

What does this mean for nonprofits? This proposal would require a nonprofit CEO to sign an affidavit that *under penalties of perjury . . .* that the organization's Form 990 complies with the Internal Revenue Code and that 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, there would be some very high-profile nonprofit executives 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 a 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 Form 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 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 its financial statements and Form 990. 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 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 those documents currently required (Form 990), and:

- The organization’s application for tax exemption

- The organization's determination letter from the IRS
- The organization's financial statements from the five most recent years

Proposals Regarding Nonprofit Boards

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 organization. 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 conflicts-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 a Whistleblower Protection policy. 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 (ED) compensation package. Many nonprofit boards do not have access to the compensation package of the ED, as this has come under the exclusive purview of the board's executive committee.

Proposals for Government Encouragement of Best Practices

Accreditation 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 IRS 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.

The staff discussion draft recommends the following oversight provisions:

- Establish Exempt Organization Hotline for reporting abuses by charities and complaints by donors and beneficiaries.
- Information sharing with State Attorneys General, the Federal Trade Commission (FTC), 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.

The staff discussion draft recommends that:

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 remains to be seen.

California’s “Nonprofit Integrity Act” (SB1262)

Provisions That Apply to Nonprofits with Budgets in Excess of \$2 Million: The state of California passed a “Nonprofit Integrity Act” that imposes many of the features of SOX on nonprofits with budgets 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 ap-

prove 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 packages are 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.

The following points in the law apply to all nonprofits, regardless of size, in California:

- 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.

CONCLUSION

The legislative environment is emphasizing greater accountability for both the private and independent (nonprofit) sectors of the economy. As was seen in the California law, the best practices that emerged from the federal legislation are now being applied to nonprofits. Although California is one of the first states to enact such a law, other states such as New York are considering similar laws. In each of the chapters in this book, we focus on the provisions of SOX that directly apply to nonprofit organizations, and those provisions that could serve as “best practices” for the nonprofit sector.

ENDNOTES

1. “Financial irregularities prompt shakeups at Beard Foundation,” *San Francisco Chronicle* (September 15, 2004).
2. Mark W. Everson, testimony before the U.S. Senate Finance Committee, Washington, DC, June 2004.