

# **SARBANES- OXLEY AND NONPROFIT MANAGEMENT**

- **Skills**
- **Techniques**
- **Methods**

**Peggy M. Jackson, DPA, CPCU**

**Toni E. Fogarty, PhD, MPH**

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Skills, Techniques, and Methods

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AND  
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For Paul, the love of my life.

PMJ

In loving memory

Louise Davis (Maw Maw)

TEF





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Peg would also like to acknowledge the support and encouragement she receives from friends, family, and colleagues. Paul, Rick, and Jan keep things in humorous perspective. Support from her Business Alliance colleagues at the San Francisco Chamber of Commerce and from her colleagues in the San Francisco Junior League has been steadfast and a source of inspiration.

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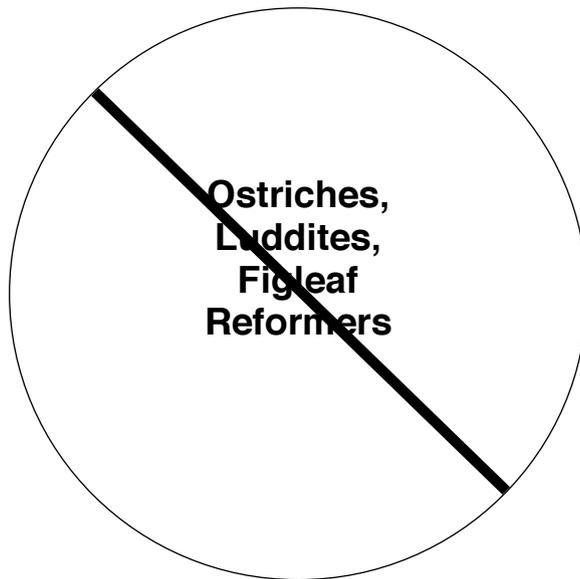
nancial controls. She also brought a lot of enthusiasm to the project, even when working on the bibliography!

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# Preface

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**W**hat’s an ostrich, Luddite, or fig-leaf reformer? Dean Zerbe, senior aid to Senator Charles Grassley (R–Iowa) commented in an interview with the *Chronicle of Philanthropy* that he routinely encounters these three groups of nonprofit people. He defines them as “Ostriches . . . deny problems; Luddites believe there is no need for change but advocate stiffer enforcement of nonprofit laws; and fig-leaf reformers come up with ideas that appear to offer solutions but actually allow problems to persist” (Woverton, 2005, p. 38).

This book is for nonprofit board members, managers, and staff who understand that the world in general and the nonprofit world in particular have changed dramatically in the past three years. The passage of Sarbanes–Oxley (SOX) legislation introduced a new management paradigm and higher levels of accountability and transparency across all economic sectors—including the nonprofit world. From the reaction of some sectors of the nonprofit world, it would appear that resistance is still the order of the day.

Mr. Zerbe is right on all three counts. In this book, you will see examples of all three “species.” The difficult truth for many nonprofits is that SOX and its best practices describe what businesses and nonprofits should have been doing all along! This book will take the reader through the history of this legislation, how SOX has influenced state legislation, and the ways in which your nonprofit can implement SOX requirements and best practices.

Here are five reasons why ostriches, Luddites, and fig-leaf reformers should become endangered species:

- The Internal Revenue Service (IRS) has committed to hold Executive Directors, CFOs, or other senior management criminally liable for veracity of financials and Form 990s.
- Banks that are publicly traded entities (which means they have to be in compliance with SOX) are requiring their clients—including nonprofits—to also be in compliance with SOX.
- SOX best practices are becoming the platinum standard for management.
- All boards (corporate and nonprofit) are being held more accountable by the federal government and its regulatory agencies such as the IRS.
- Donors, foundations, and other sources of funding will demand transparency. Being in compliance will give your nonprofit a competitive advantage.

Now, more than ever, your nonprofit needs to move to a higher level of accountability, transparency, and productivity. This book is your roadmap to the future!



# History and Legislative Background of the Sarbanes-Oxley Act of 2002

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The scene is an elegant Minneapolis restaurant. Five professionals 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, 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!*

## CHAPTER OVERVIEW

Although the Sarbanes-Oxley Act (SOX) of 2002 was passed primarily in response to wrongdoing and fiscal mismanagement in public companies, one of its effects has been to promote greater accountability within both the nonprofit and private sectors. Although the majority of management, finance, and accounting scandals in the early years of the 21st century involved public companies such as Enron, WorldCom, Adelphia Communications, and AOL Time Warner, the nonprofit world had its share of high-profile scandals, such as those involving the American Red Cross and the United Way. Recent Senate Finance Committee hearings, testimony from Mark W. Everson (Commissioner of the Internal Revenue Service), and passage of the Nonprofit Integrity Act in California all suggest a growing mistrust in the integrity of the nonprofit sector and

a call for accountability. To better understand the implications of SOX on nonprofits, this chapter will review the legislation and its legislative roots, the two SOX provisions that currently apply to nonprofits, the scandals that drove passage of SOX, pertinent Senate hearings and reports, and the efforts to adopt SOX “clones,” targeting nonprofit accountability.

## CHAPTER OBJECTIVES

By the end of this chapter, you should be able to:

- Identify the composition requirements and responsibilities of the Public Company Accounting Oversight Board
- Outline the general requirements of SOX pertaining to auditor independence, the role of the audit committee, and the corporate responsibility for financial reports
- Define the concepts of internal controls for financial reporting and disclosure controls
- Summarize corporate accountability for document preservation and whistleblower protection
- Identify the SOX provisions that currently apply to all corporations, including nonprofits
- Discuss the testimony of relevant witnesses at the 2004 and 2005 hearings of the U.S. Senate Finance Committee
- Outline the general requirements of the Nonprofit Integrity Act of 2004 (SB 1262) in California
- Discuss the proposals made by the Panel on the Nonprofit Sector and released by the Congressional Joint Committee on Taxation in 2005

## PASSAGE OF THE SARBANES-OXLEY ACT OF 2002

The Public Company Accounting Reform and Investor Protection Act of 2002 (P.L. 107–204), which typically is referred to as the Sarbanes–Oxley Act (SOX) of 2002, was signed into law by President George W. Bush on July 30, 2002. SOX has been described as the “most far-reaching reforms of American business practices since the time of Franklin Delano Roosevelt” (Office of the Press Secretary, 2002). Only the Securities Act of 1933 and the Securities Exchange Act of 1934 rival the act in its effects on public accounting, financial disclosure, and corporate governance. The act significantly broadens the authority and resources of the Securities and Exchange Commission (SEC) to monitor and regulate the securities market, and provides stiff penalties for noncompliance. In essence, the legislation complements the aim of the Securities Act of 1933 to provide “truth in securities” by improving the quality of financial report-

ing, independent audits, corporate accountability, and accounting services for public companies.

Compared to other legislative acts passed by Congress, SOX became law relatively quickly. On February 14, 2002, House Representative Michael G. Oxley (R-OH), the Chairperson of the House Committee on Financial Services, introduced H.R. 3763 (H.R. 3763, 2002). The purpose of the proposed legislation was “to protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws, and for other purposes.” The bill had 30 House cosponsors, and was passed by the House on April 24, 2002 by a vote of 334 to 90.

On June 25, 2002, Senator Paul S. Sarbanes (D-Maryland), the Chairperson of the Senate Committee on Banking, Housing, and Urban Affairs, introduced S. 2673 (S. 2673, 2002). The purpose of this proposed legislation was “to improve quality and transparency in financial reporting and independent audits and accounting services for public companies, to create a Public Company Accounting Oversight Board, to enhance the standard setting process for accounting practices, to strengthen the independence of firms that audit public companies, to increase corporate responsibility and the usefulness of corporate financial disclosure, to protect the objectivity and independence of securities analysts, to improve Securities and Exchange Commission resources and oversight, and for other purposes.” The Senate passed the bill on July 15, 2002 by a vote of 97 to 0.

Both the Senate and the House almost unanimously passed the Conference Committee Report (H.R. Rep. No. 107-610, 2002) that resolved differences in the two bills, 423 to 3 in the House and 99 to 0 in the Senate. On July 30, 2002, President George W. Bush signed the bill, and the sweeping reforms required by the act became public law (P.L. 107-204, 2002).

## **ANALYSIS OF THE LEGISLATIVE AND REGULATORY CONTENT OF SOX**

As can be seen in Exhibit 1.1, SOX (P.L. 107-204, 2002) consists of 11 titles, with each title having multiple sections:

### **Title I: Public Company Accounting Oversight Board**

Section 101 of Title I in SOX created the Public Company Accounting Oversight Board (PCAOB), which has extensive authority to monitor and regulate the audits and auditors of publicly held companies.

### **Funding Sources and Budget**

The PCAOB is a nonprofit organization that is funded by public accounting firms and publicly held companies; the PCAOB is not a U.S. government agency. Partial funding for the PCAOB comes from the registration application fees and annual fees

of public accounting firms that want to be authorized to provide auditing services to publicly held companies. Although the PCAOB has the authority to levy annual fees to offset the costs of reviewing annual reports submitted by the registered firms, it has not yet done so. Currently, the requirement for registered firms to submit annual reports has not been initiated. Since there are no annual reports to review, there are no reviewing costs and thus no annual fees. Once the requirement for the submission of annual reports is initiated, registered firms will be charged an annual fee. Additional funding comes from “accounting support fees” paid by companies defined as “issuers.”

## EXHIBIT I.1

## SOX TITLES AND SECTIONS

| Title  | Section  |
|--|--|
| I. Public Company Accounting Oversight Board | 101: Establishment, administrative provision<br>102: Registration with the Board<br>103: Auditing, quality control, and independence standards and rules<br>104: Inspections of registered public accounting firms<br>105: Investigations and disciplinary proceedings<br>106: Foreign public accounting firms<br>107: Commission oversight of the Board<br>108: Accounting standards<br>109: Funding      |
| II. Auditor Independence                     | 201: Services outside the scope of practice of auditors<br>202: Pre-approval requirements<br>203: Audit partner rotation<br>204: Auditor reports to audit committees<br>205: Conforming amendments<br>206: Conflicts of interest<br>207: Study of mandatory rotation of registered public accounting firms<br>208: Commission authority<br>209: Considerations by appropriate State regulatory authorities |
| III. Corporate Responsibility                | 301: Public company audit committees<br>302: Corporate responsibility for financial reports<br>303: Improper influence on conduct of audits<br>304: Forfeiture of certain bonuses and profits<br>305: Officer and director bars and penalties<br>306: Insider trades during pension fund blackout periods<br>307: Rules of professional responsibility for attorneys<br>308: Fair funds for investors      |
| IV. Enhanced Financial Disclosures           | 401: Disclosures in periodic reports<br>402: Enhanced conflict of interest provisions<br>403: Disclosure of transactions involving management and principal stockholders<br>404: Management assessment of internal controls<br>405: Exemption<br>406: Code of ethics for senior financial officers   |

| Title   | Section   |
|---|---|
|   | 407: Disclosure of audit committee financial expert<br>408: Enhanced review of periodic disclosures by issuers<br>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<br>602: Appearance and practice before the Commission<br>603: Federal court authority to impose penny stock bars<br>604: Qualifications of associated persons of brokers and dealers   |
| VII. Studies and Reports                          | 701: GAO study and report regarding consolidation of public accounting firms<br>702: Commission study and report regarding credit rating agencies<br>703: Study and report on violators and violations<br>704: Study of enforcement actions<br>705: Study of investment banks   |
| VIII. Corporate and Criminal Fraud Accountability | 801: Short title<br>802: Criminal penalties for altering documents<br>803: Debts nondischargeable if incurred in violation of securities fraud laws<br>804: Statute of limitations for securities fraud<br>805: Review of Federal sentencing guidelines for obstruction of justice and extensive criminal fraud<br>806: Protection for employees of publicly traded companies who provide evidence of fraud<br>807: Criminal penalties for defrauding shareholders of publicly traded companies |
| IX. White Collar Crime Penalty                    | 901: Short title<br>902: Attempts and conspiracies to commit criminal fraud offenses<br>903: Criminal penalties for mail and wire fraud<br>904: Criminal penalties for violations of the Employee Retirement Income Security Act of 1974<br>905: Amendment to sentencing guidelines relating to certain white-collar offenses<br>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            | 1101: Short title<br>1102: Tampering with a record or otherwise impeding an official proceeding<br>1103: Temporary freeze authority for the Securities and Exchange Commission<br>1104: Amendment to the Federal Sentencing Guidelines<br>1105: Authority of the Commission to prohibit persons from serving as officers or directors<br>1106: Increased criminal penalties under Securities Exchange Act of 1934<br>1107: Retaliation against informants                                       |

*Registration Application Fee* As can be seen in Exhibit 1.2, the amount of the application fee varies, dependent upon the number of issuer clients the applying firm audited during the year previous to the application. For firms with more than 100 clients, the fees are significantly higher than for those firms with fewer than 101 clients (Public Company Accounting Oversight Board, 2004; Public Company Accounting Oversight Board, 2005).

*Accounting Support Fee* A major source of funding for the PCAOB is the “accounting support fee,” which is paid by “equity issuers” and “investment company issuers.” The PCAOB defines equity issuers as publicly traded companies with average monthly equity market capitalization greater than \$25 million during the prior calendar year. Investment company issuers are registered investment companies and issuers that have chosen to be regulated as business development companies and had an average monthly market capitalization or net asset value greater than \$250 million during the prior calendar year. The total amount of the accounting support fees is equal to the SEC-approved PCAOB budget, less the amounts collected in the previous year from registration application fees and annual fees. The basis for the accounting support fee paid by individual equity issuers and investment company issuers is the relative average monthly U.S. market capitalization. Each issuer’s share is its average monthly U.S. market capitalization during the preceding calendar year, divided by the sum of the average monthly U.S. market capitalization of all equity and investment company issuers (PCAOB, 2005).

*Budget* The PCAOB develops its budget and submits it to the SEC for approval. In the 2004 PCAOB budget, the net outlays were \$103.297 million. The registration application fees for 2003 totaled \$2.050 million, making the total accounting fee

EXHIBIT 1.2

REGISTRATION APPLICATION FEE

| Number of Issuer Clients | Fee       |
|--------------------------|-----------|
| 0                        | \$250     |
| 1-49                     | \$500     |
| 50-100                   | \$3,000   |
| 101-1000                 | \$29,000  |
| 1001 and greater         | \$390,000 |