

# THE SARBANES-OXLEY ACT: DOES IT APPLY TO NONPROFITS?

By William H. Sims, CPA

**T**HE AMERICAN Competitiveness and Corporate Accountability Act of 2002 (otherwise and more commonly known as the Sarbanes-Oxley Act) was the U.S. Government's response to the corporate scandals of the last few years, namely Enron, Tyco, WorldCom, and Adelphia Communications.

The confidence of individual investors, regulatory agencies and national leaders in corporate management's ability to implement and monitor systems to detect fraud was severely shaken. The resulting public outrage at the extent of these frauds brought into question the financial reporting system used by corporate America. As a result, Congress passed, and the President signed, the Sarbanes-Oxley Act (SOX) in July 2002.

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**WHILE THE THRUST OF THE SARBANES-OXLEY LEGISLATION IS DIRECTED AT PUBLICLY TRADED CORPORATIONS, THE PASSAGE OF THIS BILL SHOULD CAUSE THE NONPROFIT COMMUNITY TO TAKE NOTE AS WELL.**

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The purpose of SOX is to rebuild the public trust in America's corporate sector by establishing new governance standards. While the thrust of the SOX legislation is directed at publicly traded corporations, the passage of this bill should cause the nonprofit community to take note as well. New York Attorney General Elliott Spitzer has been a leading proponent of applying the SOX provisions to nonprofits. If Mr. Spitzer is successful in requiring New York organizations to adhere to the SOX provisions, then other states might follow.

Even if Mr. Spitzer is unsuccessful, nonprofit organizations are not necessarily off the hook if they ignore SOX. As investors, regulators, creditors, and the donor community get comfortable with the increased reporting for public companies under SOX, it is very likely that they will start asking nonprofits to adhere to some or all of the provisions in SOX. There is some speculation that at least some of the SOX provisions will

apply, in time, to several groups of "public interest" entities. Those public interest entities could include nonprofit organizations—particularly those that receive some amount of public support, state and local governments, and employee benefit plans.

In order to be proactive, nonprofit boards and management should consider whether to adopt certain governance provisions of Sarbanes-Oxley. In effect, many of these provisions could become best practices for nonprofit organizations.

The following items are practices which were either established by SOX or other regulations and some of which are considered best practices for nonprofit organizations:

- A nonprofit should consider increasing the number of independent members of its governing board to ensure that at least some of them

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have experience in accounting and financial matters.

- If a nonprofit doesn't have an audit committee, one should be considered and established—particularly if the organization is of sufficient size. If an audit committee does exist, it should review its governance to make sure it operates within the guidelines of SOX.
- Loans to executives and board members should be limited, if not prohibited. In particular, loans with provisions that forgive all or a portion of the loan principal should be eliminated.
- A nonprofit organization should have a conflict of interest policy. For those organizations that have such a policy, it should be reviewed to see if it needs updating.
- The lead audit partner or executive should rotate off of the audit every five years.
- The CEO, Controller, CFO, ED, and/or persons in equivalent positions, should not have been employed by the organization's audit firm during the year preceding the audit (unless the audit committee has been directly and sufficiently involved in the audit).
- A nonprofit organization should develop and implement a zero-tolerance policy for unethical and illegal behavior.
- The audit or finance committee should establish procedures to document and resolve complaints received regarding improper accounting practices and breakdowns in internal controls to ensure that employees are given "whistleblower protection." These procedures should ensure that any employees who come forward with information to the audit committee are not subjected to punitive measures by the organization.
- Nonprofit organizations need to think through their document retention policies as SOX addresses destruction of litigation-related documents. Therefore, any intentional document destruction must now be monitored, justified and carefully administered. It is still reasonable and permissible to have a document retention (and disposal) policy, but an organization must exercise caution if any litigation is involved or expected.

In conclusion, Sarbanes-Oxley has been in force for over a year now. During this time of intense corporate scrutiny, SOX is forcing nonprofit organizations to evaluate their board governance and methods of operation. Regardless of the driving force behind these actions, nonprofit organizations have the opportunity to take a look at their own governance policies and procedures. Proactive steps by organizations will hopefully keep the regulators from stepping in and imposing their own set of rules and regulations. 