

The Sarbanes–Oxley Act Will Change the Governance of Non Profit Organizations

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ABSTRACT. As a public director of a NASDAQ stock exchange listed public corporation, I have seen how quickly the reforms in corporate governance imposed by the Sarbanes–Oxley Act have changed procedures and policies in public corporations. In areas such as transparency of financial records and other financial matters including compensation of top executives and conflict of interest policies affecting both corporate boards of directors and employees of the corporation the reforms of this new federal law have quickly changed corporate practices in many corporations. Many persons who have studied this new law believe that these changes will benefit the public, shareholders, employees, and other stakeholders in the modern corporation by increasing the reputation of these organizations for integrity and transparency. Stock exchanges such as NASDAQ and the New York Stock Exchange now require all listed companies to have (after a transition time) a majority of independent directors on their boards of directors. Only independent directors may serve on the audit, nominating and compensation committees of boards in most cases. Some exceptions are made to these rules for foreign and domestic issues of companies where a majority of the voting power is held by one person. According to Morrison & Foster LLP, *Corporate Board Advisory* March, 2004, NASDAQ requires that the board of directors of a listed company determine that an independent director does not have a relationship that would “interfere with the exercise of independent judgment” in carrying out the responsibilities of a director.

KEY WORDS: independent directors, transparency

It is likely that the principles of transparency and requirements for independent directors to serve on audit, nominating and compensation committees of listed for profit corporations will eventually be applied to non profit organizations such as universities and other charitable agencies as a result of probable future court decisions, government regulatory actions, and regulations of accreditation agencies.

Stakeholders in non profit organizations such as faculty, students, and alumni of colleges and patients, doctors and hospital workers in hospitals will begin asking why the same reforms that have been imposed on directors of corporations should not also be imposed on trustees of non profit organizations. Members of boards of trustees of non profit organizations like members of boards of directors of public for profit corporations have fiduciary responsibilities such as due care that may be affected by court decisions based upon the Sarbanes–Oxley Act. Boards of trustees of non profit organizations in both public and independent colleges and universities, for example, will inevitably become more accountable to their stakeholders including students and other clients and to the public as has already occurred recently for public for profit corporations.

Public attention was first focused on the boards of directors of public for profit corporations because of alleged abuses in large corporations such as Enron, Tyco, and others. Public attention is now swinging toward greater scrutiny of non profit organizations such as colleges and universities, charities, hospitals and other non profit organizations. Since the terrorist attacks on 9/11, there have been frequent headlines on the alleged mishandling of funds donated by the public to charitable organizations to help victims and relatives of victims of the terrorist attacks. These headlines have led to more scrutiny of

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these organizations. Other recent media headlines involving compensation of chief executive officers of universities, selection and retention/firing of university presidents in several well-publicized incidents, and escalating tuition costs have raised questions about the governance of universities and colleges affecting both the public and independent sectors of higher education.

There is yet no federal law or regulation requiring many non profit organizations to provide audited financial statements to the public. Non profit organizations are generally required to file a form 990 tax return with the Internal Revenue Service. Some state attorney generals, such as Attorney General Eliot Spitzer of New York, are pushing for state legislation to require the chief executive officer and the chief financial officer of charitable organizations to certify that the financial statements of the organizations are accurate and complete and to adopt other Sarbanes-Oxley requirements such as public reporting of financial results similar to those now imposed on public for profit corporations.

Already, some non profit organizations have agreed to meet the requirements of Sarbanes-Oxley even though all of these requirements may not yet be required by law for nonprofit organizations. For example, the Board of Trustees of Drexel University have revised its by-laws to meet all of the requirements of Sarbanes-Oxley. It seems to be likely that nonprofit organizations will soon be required by legislation or regulations to publish their financial statements and distribute these statements to stakeholders as is now required for public for profit corporations. Many non profit organizations do this already, although some try to keep their financial statements secret.

When accounting rules for non profit organizations change, such as the new requirement for independent colleges to account for depreciation, boards of trustees of non profit universities, in the interest of full disclosure and financial transparency of what they do, should consider recasting the results for the previous year(s) using the new accounting rules so that results can be compared easily from one year to the next. Fiscal transparency is needed to help restore public confidence in the integrity of charitable institutions just as it is important for public for profit corporations.

Members of boards of trustees need to push their boards to adopt written policies and procedures to prevent conflicts of interest in what they and the employees of the non profit organization including professional employees, staff, and administrators as well as members of the board of trustees to meet the spirit of Sarbanes-Oxley. For example, the scandal of awarding a non profit organization's insurance business to a firm owned by a trustee without using a system of sealed bids after developing suitable specifications and similar scandals involving provision of services to the non profit organization by a member of the board of trustees for what may be an unusually generous fee seem to reoccur again and again in the headlines. Boards need written policies to avoid these problems.

The Internal Revenue Service has imposed new penalties on conflict of interest problems at colleges and universities where the officer(s) or trustee(s) have benefited beyond the fair market value of the transaction in the form of taxes that will be levied on the organization and fines that may be levied by the IRS on the persons involved. These regulations may also be applied to other non profit organizations in the future.

Compensation of top administrators of non profit organizations should be decided only after review by a special board compensation committee made up solely of independent trustees with the help of outside consultants on compensation and results should become public knowledge to help insure the integrity of the process and the fairness of the results. Compensation of senior officers of for profit public corporations is required to be publicly disclosed. The same should be true for senior officers of non profit organizations to benefit the public and better protect members of the board.

The day of the public avoiding serious scrutiny of the governance of non profit organizations, because of the charitable nature of the purpose of the organizations is waning. Members of boards of trustees, administrators, professional employees and staff also need to become more concerned about liability for problems arising from lack of financial transparency and from conflicts of interest. A good directors and officers liability insurance policy is essential to help protect boards, administration, and other employees from unwarranted lawsuits in the years ahead. A better protection for all is the sunshine provided by

financial transparency and by appropriate governance provisions regarding conflict of interest and compensation issues.

The corporate reforms brought about by Sarbanes-Oxley will inevitably spread to non profit organizations. One of the possible drawbacks of these reforms is that persons may become more reluctant to serve on boards of trustees of non profit organizations, because of the increased scrutiny that will occur with operating in the sunshine. Directors of public for profit corporations who are used to such scrutiny will be expected along with other trustees of non profit organizations to undergo such scrutiny for their service on charitable boards. It is my belief that the benefits brought to non profit organizations as a result of greater transparency and increased public review of what happens in governance of non profit organizations resulting in greater public confidence in the integrity of non profit organizations will outweigh the consequential increased problems of recruiting good trustees from the ranks of members of boards of directors of public for profit corporations to serve on the boards of non profit organizations.

Persons of integrity who have knowledge of business and other fields can benefit society by serving on the boards of charitable non profit organizations. Such service shows their commitment to improve non profit organizations to the benefit of society. Knowledge gained from service on non profit boards and networking with other members of the non profit board along with satisfaction in helping non profit organizations succeed probably would continue to attract persons of ability to serve on the boards of non profit organizations even with Sarbanes-Oxley type regulations despite lack of financial compensation for members of non profit boards.

The reforms of Sarbanes-Oxley will likely spread to non profit boards of trustees. The likely resulting increase in public trust in the integrity of our non profit organizations and of their boards of trustees will benefit all concerned.

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