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HOW TO KEEP TAX EXEMPT ORGANIZATIONS IN COMPLIANCE

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THE IMPACT OF SARBANES OXLEY AND THE ERA OF CORPORATE GOVERNANCE ON NON-PROFIT ORGANIZATIONS

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A. Sarbanes Oxley – A Brief Walk Through of the Act

The Sarbanes Oxley Act (P.L. 107-204), known in shorthand as "SOX," was passed in the summer of 2002, in response to a growing number of financial scandals of for-profit companies that issue securities, including, but not exclusively, Enron, World Com, Global Crossing, Tyco, Adelphia Communications, and others. As those scandals unfolded, it was clear that there had been enormous manipulation of financial data and corporate assets, rightfully owned by shareholders, by CEO's and senior executive officers for their personal enrichment, to deceive the public auditors. In addition, in some cases, there was assistance by financial experts and accountants.

In response to the public outrage generated, and recognizing that the Securities and Exchange Commission ("SEC"), the body charged with regulation at the federal level of publicly traded securities, was unable to do its job, due to the lack of transparency, honesty and accuracy in the financial statements of those companies, Congress enacted sweeping reforms for auditors and senior corporate officers. The Sarbanes Oxley Act required the SEC, and other public agencies charged with regulating publicly regulated securities, to enact auditing and governance reforms for those companies. Several stock exchanges, including the New York Stock Exchange, also enacted voluntary reforms of their own that further require additional governance reform.

The principal features of the Sarbanes Oxley Act, and the voluntary reforms enacted by stock exchanges include:

- Financial and auditing reforms;
- Reforms of compensation of senior executives;
- Additional disclosure of material financial and other information;
- Composition and operation of boards of directors responsible for the oversight of public companies.

Concerns about adequate auditing standards, the independence of auditors and boards of directors, and the transparency and truthfulness of information in corporate financial statements sparked broader concerns about appropriate corporate governance of public companies.

B. Applicability of Sarbanes Oxley to All Companies (Public/Non-Public).

1. The statutory requirements of the Sarbanes Oxley Act primarily addressed auditing problems and financial manipulation. In addition, broader concerns regarding reform of governance issues at the board and corporate level also followed from the outrage over the scandals, and from the reforms required by the Sarbanes Oxley Act. What follows is a brief overview of the principle terms of the Sarbanes Oxley Act, most portions of which are not explicitly applicable to non-profit organizations. However, for some non-profit organizations with close parallels in the for-profit world, such as large non-profit hospitals and healthcare organizations, some of the same accounting and auditing reforms may be relevant. The Sarbanes Oxley Act is divided into 11 sections or "titles." The summaries below cover each title. Those with direct applicability by their terms to non-profit organizations or their officers and directors are bolded.

- Title I . Public Company Accounting Oversight Board

  This Title mandates the creation of a Public Company Accounting Oversight Board to oversee audits of public companies and to improve the information in audit reports to make it more informative, accurate and independent. The Accounting Oversight Board is required to register, discipline and inspect public accounting firms, and to adopt auditing, ethical, independence and other standards for their work. The Accounting Oversight Board has already taken steps to promulgate rules to require more independence on the part of auditing firms, and to limit the kinds of non-audit related services that they can provide to public company clients.

- Title II. Auditor Independence.

  Auditing firms that audit publicly traded corporations are prohibiting from also offering the following, non-audit services: bookkeeping, financial system design, appraisal, actuarial, management or human resource services, investment advising or broker/dealer services, legal services or other expert services unrelated to the audit, and any other services the Accounting Oversight Board, above, prohibits.

  This title also sets up the expectation that publicly traded companies will have an Audit Committee comprised of non-insiders, charged with independent review of the audit, and approval of any non-audit services of the auditor, to promote more independence on the part of the auditor, and less inter-dependence with the CEO or the members of the Board of Directors who may be insiders. In addition, the auditors are required to provide timely reports to the Audit Committee on all the critical accounting policies and practices used in the audit, all alternative treatments of financial information within generally accepted accounting principles ("GAAP"), discussed with the company management and the ramifications of using such alternatives. This title also requires that the lead partner in the accounting firm be rotated, at least every five years, in the role of the auditor for a particular company, and prohibits the CEO, controller, CFO, or Chief Accounting Officer of the publicly traded company, from having been employed by the auditor firm during the year prior to the audit, to enhance independence.

- Title III. Corporate Responsibility.

  This title addresses requirements for the Audit Committee of a publicly traded company, and requires that any companies not in compliance with these

requirements may not be listed on the stock exchanges and associations trading those company's securities. This is a shocking penalty. The requirements include: the audit committee must have responsibility for the appointment and oversight of the company's audit firm and be the entity to which the audit firm reports directly, the members of the Audit Committee must be so-called "independent" members of the Board of Directors, i.e., not receiving a consulting fee from the company other than compensation as a Director or committee member, and not be affiliated with the company or any of its subsidiaries; the Audit Committee must be the entity that receives and responds to complaints dealing with accounting matters, and it must have the authority to engage independent counsel and advisors, if necessary. The SEC also requires that such audit committees be appropriately funded to pay the audit firm and any advisors that are necessary.

The next section of this title pertains to the company's officers' certification of important financial documents, including the forms 10-K and 10-Q required to be filed with the SEC. These new certification rules require that the principal executive officer, such as CEO, and the principal financial officer, such as CFO, certify (1) that they have each reviewed the financial report; (2) to the best of the officer's knowledge it does not contain any materially untrue facts or omissions and is not misleading; (3) that based on the officer's knowledge the financial statements fairly represent the corporation's financial condition and operations; (4) that the officer has established internal controls designed to ensure that all material information relating to the corporation is known to that officer; and (5) that the officer has disclosed to the auditors and to the Audit Committee any significant deficiencies in the corporation's internal controls and any fraud involving any employee playing a significant role in those internal controls.

This section also deals with criminal consequences for improperly influencing the audit by an officer or director, or person acting at one of their directions to

fraudulently influence or, in any way mislead, an independent auditor in connection with the company's financial statements, and also provides for the repayment of bonuses and profits for any CEO or CFO when accounting statements need to be restated due to material non-compliance with <u>any</u> financial reporting requirement under the securities law. These penalties are designed to add bite to the disclosure laws.

This title also required the SEC to develop rules of professional responsibility for attorneys practicing before it, representing public companies. The SEC adopted rules requiring an attorney to report "up the corporate ladder," evidence of violations of securities laws or breaches of fiduciary duties, ultimately to the CEO and/or Audit Committee.

- Title IV. Enhanced Financial Disclosures

This section requires an annual and quarterly report of any material off-balance sheet transactions and other pro forma financial information. This title also has a prohibition on personal loans or extensions of credit to an officer or director by the company, either directly or indirectly. It requires additional disclosures promptly of any insider trading of securities and related derivatives by directors, executive officers, and shareholders owning more than 10% of any class of the company's equity securities. There are new rules for information on the management's assessment of the internal controls in place, to be disclosed on Form 10-K. This also requires confirmation by the audit firm. Furthermore, an ethics code is required for senior financial officers, or an explanation if there is none, and any disclosure on a Form 8-K of any changes to or waivers from the ethics code.

Additionally, the SEC must require each company to disclose whether or not its Audit Committee has one member who is qualified as a "Financial Expert" as

defined by the SEC, and if not to explain why. Finally, this title requires more up-to-date and clear disclosures of any material changes to the company's financial conditions or operations, and more frequent and systematic reviews of periodic filings by the SEC.

- Title V. Analyst Conflict of Interest.

  This title requires that the SEC take action to assure the objectivity of all securities' analysts and the research reports they produce on public companies, by requiring conflict of interest disclosures.

- Title VI. SEC Resources and Authority.

  This title addresses the need for additional funding for the SEC to carry out its mandates under this Act. It also provides it with additional authority to temporarily or permanently bar from practice any person whom the SEC has found to be unqualified or lacking in character or integrity, or who violated or aided and abetted the violation of any federal securities laws or SEC rules or regulations.

- VII. Studies and Reports.

  This title requires the U.S. Comptroller General to conduct a study and issue a report regarding the causes and effects of consolidation of public accounting firms and whether investment banks or security advisors have assisted public companies in manipulating their earnings, or misleading the public as to their true financial condition. The SEC is charged with studying and reporting on the rule of credit rating agencies, and from 1998 to the end of 2001, the number and nature of professionals involved in violating or aiding or abetting the violation of federal securities laws, and a review of SEC enforcement actions for the five years prior to

the Sarbanes Oxley Act on violations of reporting requirements and financial statement re-statement needs, as well as an identification of those areas most likely to be the subject of fraud or inappropriate earnings statements.

- Title VIII. Corporate and Criminal Fraud Accountability.

This title includes sections applicable to both non-profit and for-profit organizations.

This title creates new criminal offenses punishable by fines and/or imprisonment of up to 20 years for **any person** (i.e., not only an executive of a publicly traded company) to **knowingly destroy or create documents with the intent of impeding, obstructing or influencing the investigation or administration of any matter within the jurisdiction of any U.S. agency or department (i.e., not only the SEC).** This creates a federal crime for document destruction, falsification or concealment for any federal agency or department investigation.

This title requires an accountant to keep audit work papers for five years, and requires the SEC to prescribe regulations relating to the retention of appropriate audit work papers and other documents, a violation of which will be punishable by fines and up to 10 years of imprisonment.

This title created federal sentencing guidelines for obstruction of justice and criminal fraud; however; in subsequent cases, the U.S. Supreme Court held those guidelines to be advisory, not mandatory, from the U.S. Sentencing Commission. See United States v. Booker, 543 U.S. 220 (2005).

This title also created protection for whistleblowers who are employees of publicly traded companies, if they are discharged, demoted, harassed or subjected to any other adverse employment action, because the whistleblower provided information or assisted a federal agency, member of Congress, or a person with supervisory authority over that employee in an investigation regarding mail fraud, wire fraud, or securities fraud, or participated in any proceeding related to a securities fraud.

This title also provides criminal penalties for securities fraud of up to 25 years in prison, for any knowing attempt to obtain money or property from any person in connection with any public company's security or the purchase or sale of such a security.

- Title IX. White-Collar Crime Penalty Enhancements.

  This title created enhanced penalties for mail and wire fraud, and directed revised recommendations from the Federal Sentencing Commission for such penalties (although as noted above those are advisory only, pursuant to U.S. Supreme Court decisions). This title also provides the penalties for any "knowingly" insufficient certification of the SEC Forms 10-Q and 10-K, required to be certified to by a company's CEO and CFO. The penalties may be increased up to $5,000,000, and imprisonment may be increased to 20 years for any "willful" violation.

- Title X. Corporate Tax Returns.

  This section provides only a "sense of the Senate" resolution that federal income tax returns of a publicly traded corporation should be signed by the company's CEO.

- Title XI. Corporate Fraud Accountability.

  This title includes important provisions that are applicable to both publicly traded and not-for-profit organizations: fines and imprisonment for up to 20 years for anyone who "corruptly" either attempts, or succeeds, in altering, destroying, mutilating, or concealing a record, document or other object in order to impair its use in an official proceeding, or otherwise obstructs, influences or impedes an official proceeding "corruptly."

  This title also has a section on requiring the U.S. Sentencing Commission to consider reviewing and enhancing penalties for securities and accounting fraud and related offenses, and to promulgate new guidelines.

  In addition, this title has a new section on the imposition of fines and imprisonment for up to 10 years for any person who "knowingly, with the intent to retaliate" causes harm to another person, including adverse employment or livelihood actions, because the person provided truthful information to a law enforcement officer relating to the actual or possible commission of any federal offense.

  This is an extremely broad protection for whistleblowers for providing truthful information on any federal offense whatsoever, not limited only to securities fraud.

2. Most Provisions of Sarbanes Oxley Act Do Not Apply Directly to Non-Profits.

As noted above, most of the provisions of the Sarbanes Oxley Act do not apply directly by their terms to non-profit organizations. The exceptions are in Title VIII and Title XI, pertaining to penalties for obstruction of justice, document destruction, and retaliation against whistleblowers. Those are important sections, and all non-profit organizations should be aware that they are applicable to them. Because this is still a relatively new area, many non-profit organizations may not have internalized the protocols necessary to address the fact that they are now subject to significant penalties in these areas. For this reason, we recommend the following to all of our non-profit clients:

- Develop, implement and review annually an appropriate document destruction policy to make sure that it complies with not only the other regulations that pertain to document destruction limits, such as tax statutes of limitations, employment and other types of records, but also comply with the new Sarbanes Oxley requirements, and

- Develop an appropriate policy for protection of whistleblowers who may complain to either management or an outside regulatory agency about any perceived illegal actions by the organization.

As also noted above, there are growing suggestions that many of the accounting and audit requirements for Sarbanes Oxley may be appropriate and relevant for large non-profit organizations with parallel, for-profit counterparts, such as healthcare organizations and hospitals. We recommend that such organizations begin implementation of appropriate auditing safeguards and protocols including the creation of an Audit Committee, with authority and independence, as well as requirement for accuracy of information and assurances that accurate, material information is provided all the way up through the CEO and CFO. The Audit

Committee could be the same as the Finance Committee in many organizations. Whether or not certification by a CEO or CFO of the financial statements is appropriate may depend on individual circumstances.

In addition, we recommend the development of financial expertise on the part of at least one member of the Audit Committee. The Sarbanes Oxley Act recognizes that members may not come to a board of directors with financial expertise, but some, at least, must be willing to develop that expertise in order to be able to serve the organization appropriately. While this is directly applicable to for-profit organizations, it has equal relevance to not-for-profit organizations as well, and board members should be encouraged to develop that financial "literacy" to be able to guide their organizations appropriately.

C. Board Governance Considerations.

The echoes from the Sarbanes Oxley Act that have resounded in both publicly traded companies and non-profit organizations have pertained as much to board governance and independence matters as to financial matters. Part of what emerged from the scandals preceding the Sarbanes Oxley Act's enactment was a growing recognition that both for-profit and non-profit boards were too often lacking in the independence needed both in terms of the board members' affiliations, and in the organization's culture, more inclined to encourage acquiescence than independent review and oversight by the board of directors. As a consequence, there have been many attempts to promote review of and strengthening of the independence of boards charged with governing for-profit and not-for-profit organizations. Because the role of the not-for-profit board in some ways is greater than that of a for-profit board, since there are no shareholders to provide the layer of oversight present in a publicly traded corporation, the next section will focus on some recommendations for board governance reform for non-profit organizations.

- What is the Board's Role?

  One of the concerns that emerged pre-Sarbanes Oxley was the need to have boards of directors exercise more in-depth, well-informed and objective oversight of their organizations as had been done in the past. The board must also set an ethical tone, and a culture in which inquiry and informed comments are welcomed and encouraged.

  In addition, there are many mechanical items that can be addressed to enhance the effectiveness of boards, and it is recommended that boards undertake a review of structure and operations, to ensure that they are operating as effectively as possible. Although many of board practices and structures are enshrined in by-laws, long-standing practice, or both, it will strengthen those organizations to review such practices, keep those whose efficacy is confirmed, and change those that need changing. A number of items to be considered are listed below:

  - Size of Board: many boards find that they work most effectively with between 5 and 13 members. Beyond that size, either smaller or larger, they often struggle to be effective. A smaller board often does not have the resources to carry out all the board and committee work necessary, and larger boards often result in a sense of attenuated responsibility by the board members, and less feelings of individual responsibility.

  - Composition of Board: Depending on the type or organization, it is often important to have a range of individuals on the board who bring a variety of professional and work experience expertise. Sometimes non-profit boards have a number of either key donors or fundraisers on the board, and at times that can cloud the judgment of the board overall with regard to financial decisions, in an effort to not alienate those important folks.

However, the board must remain independent, and it may be less appropriate to have all large donors and those with fundraising expertise on the board, when perhaps some can be more appropriately used as chairs of committees. Additionally, some organizations are tied very closely to particular communities or subgroups within the communities. While it is often important for an organization's mission to have those attuned to those issues, it is also important not to have too narrow a board of directors.

There may be times when non-profit organizations needs to provide support, in terms of secretarial support or otherwise, to assist an independent board of directors. While it may be appropriate to get away from management of the organization, including the CEO, providing services involving the development of the agenda and items for discussion at meetings, staff support may still be important for assisting what are usually non-paid volunteer boards of directors.

- Audit Committee: An organization with significant financial resources may wish to consider the development of an independent Audit Committee, or include those functions in an independent Finance Committee. New Hampshire law already requires a financial statement, prepared in accordance with generally accepted accounting principles ("GAAP'), to be filed with the Attorney General's Office annually for those organizations with revenues of over $500,000 up to $1,000,000 per year, and audited financial statements for those with revenues of over $1,000,000. RSA 7:28,III-a-c. Even organizations with smaller budgets may wish to have an audited financial statement.

- An Audit Committee could be formed for the purpose of reviewing whether or not it is appropriate for an organization to have an audit done, either annually or less frequently. This also assists the board in carrying out its obligations under New Hampshire law requirements regarding investments. Under New Hampshire law, General Standards of Prudent Investment, RSA 564-A:3-b, boards of directors of all non-profit organizations are required to follow prudent investment standards. The statute is very broad and adopts a "total return" concept, mandating how directors must select and monitor their investment advisors. It also establishes a clear duty of loyalty and impartiality. The boards must be prudent and reasonable in their choices, and have a duty to monitor investments, as well as a duty to diversify assets. "Diversification" relates to the asset allocation, or the division of investments along different vehicles. This might include stocks, treasury bills, corporate bonds, and others. The proper mix for each portfolio depends upon a variety of factors, including the nature of the organization's charitable mission, the need for liquidity, the income flow and general economic conditions. The board must invest in a prudent manner, in light of the purposes of the organization. Although the board may delegate its investment function, it retains the very clear duty to monitor the returns to ensure that they are being carried out appropriately. Given those responsibilities, the notion of a periodic or annual audit may be more appealing. **HB 1382, the Uniform *Prudent* Management of Institutional Funds Act, was passed by both the New Hampshire House and Senate in April 2008, and goes into effect on July 1, 2008. It replaces, and substantially modifies, the current RSA Chapter 292-B, the Uniform Management of Institutional Funds Act.**

- Does the Organization Have a Governance/Nominating Committee?

  Non-profit organizations often have committees charged with reviewing bylaws, but notions of good governance in the wake of Sarbanes Oxley's reforms have gone far beyond periodic review of bylaws. It may be appropriate to combine the functions of a bylaws committee with those of a corporate governance committee, to address board function, structure, term limits, and director qualifications. In addition, with small organizations, this could also include the duties of the nominating committee charged with finding new candidates for board positions. If a review of board structure and procedures, as recommended above, is carried out periodically, this also would be a good committee to be charged with responsibility for organizing that, either with the use of outside experts or on its own. It is generally recommended as well, to have periodic evaluations of the effectiveness of the officers and board members.

- If Any Officers Are "Highly Compensated," There Should Be A Compensation Committee.

  The IRS has specific requirements for arm's-length negotiations and reasonable compensation for officers of a non-profit organization. It is not generally recommended that the members of the boards of non-profit charitable organizations be compensated, but often a CEO and other officers must be and, depending on the sophistication of the work needed and the budget of the organization, that compensation can frequently be above the $50,000 threshold set by the IRS for "highly compensated" individuals. See the above section on Intermediate Sanctions. A

compensation committee should review compensation of similar officers in similar organizations in similar parts of the country, and develop a range of salary options, including the entire compensation package, <u>before</u> proposing compensation for the entity's officers. All of that information should be documented and retained in the organization's files.

- Conflict of Interest Code.

  New Hampshire law requires, and IRS requirements strongly suggest, that each organization have a conflict of interest policy. In addition, many organizations also have a business/ethics code. In the case of non-profit organizations, sometimes the need for an ethics code becomes blurred because of the public nature of the organization's work. However, confidentiality and other ethical considerations are just as important for non-profit organizations as they are for for-profit organizations. It is recommended not only that each organization have a conflict of interest code that complies with IRS and state requirements, but also that other ethical matters be addressed as well.

- Monitoring Compliance and Investigating Complaints.

  We highly recommend that organizations engage in an annual review of compliance with board governance issues, as well as IRS requirements with regard to compensation and other matters. The most effective method that we have found is an annual survey that addresses, in a practical way, whether or not the board of directors understands the requirements of the conflict of interest policy, and the requirements for development of compensation for highly compensated officers, as well as

protections for whistleblowers and other legal requirements. Having a board of trustees or directors fill out such a form annually to determine whether or not the members understand the requirements of these various codes and statutes is also an excellent educational tool, as explanations for the correct answers to the questions should accompany the survey. It is not a "test" in terms of passing or failing, but an educational process that should be undertaken each year. In addition, board members should disclose any potential conflicts of interest from organizations with whom they work or organizations, or entities which they own which may do business with the non-profit organization on whose board they sit.

D. Proposal to the Senate Finance Committee.

Following the enactment of the Sarbanes Oxley law, Independent Sector, an influential organization of business and not-for-profit organizations, convened a Panel on the Non-Profit Sector to address concerns about lack of transparency and independence for non-profit boards, following some corruption scandals in the charitable sector. In its 2005 Report, the panel proposed to the Senate Finance Committee that some of the requirements of the Sarbanes Oxley law be applicable to non-profit organizations. It also made other recommendations for reform of IRS forms and regulations and suggested additional legislation by Congress. As you may be aware, the Senate Finance Committee, primarily under the leadership of Senator Charles Grassley from Iowa, the former Chair and now ranking member, has been engaged in longstanding review abuse of non-profit organizations.

The Independent Sector Report suggested reforms at the federal level, with recommended congressional action, as well as recommendations for action by charitable organizations themselves. The following is a list of the major recommendations:

- Increase resources for the IRS for oversight and enforcement of charitable organizations.

- Increase funding for state regulation of charitable organizations and education into the obligations of charitable entities.

- Give state Attorneys General charged with enforcing laws and regulating charitable entities access to the same information that the IRS has.

- Authorize the IRS to require mandatory electronic filing of all Form 990's to enable their dissemination more readily.

- Require signatures on the Form 990's by CEO's, CFO's, or other high ranking officers, or by a Trustee of a Trust, under penalty of perjury.

- Require a notification process to the IRS for all organizations with revenues under $25,000 a year, currently not required to file a Form 990 or 990-EZ.

- Have the IRS substantially reform the Form 990 and 990-PF (private foundation) for greater transparency and more comprehensive information.

- Periodic IRS review or audit of tax-exempt status of organizations.

- Require more detailed financial audits of larger charitable organizations.

- Require greater disclosure of performance data, including information on the Form 990's.

- Revise the laws on donor advised funds, to include more detailed definitions and requirements.

- Revise the laws and regulations on certain “Type III supporting organizations.”

- Crack down on abusive tax shelters involving charitable organizations.

- Limit the contributions of non-cash property, including requirements for appraisals and limitations on values claimed.

- Tighter regulations on excessive board compensation, including excess benefit transactions and self-dealing.

- Tighter rules on executive compensation for charitable entities.

- Limitation on excessive travel expenses for executives and board members of non-profit organizations.

- Reform of governing board structure, size, composition and independence.

- The creation of audit committees for charitable organizations, including individuals with “financial literacy.”

- Require conflict of interest and misconduct policies for governing boards.

Many of these recommendations were implemented by Congress in the provisions of the Pension Protection Act, which was passed in August 2006. Many not-for-profit organizations are now feeling the changes from those recommendations, and from that statute, including revised 990 Forms, limitations on donations of non-cash property, the

requirement of an "e-postcard" for small charities with revenues of under $25,000 per year, and increased emphasis on transparency and independence of governing boards.

In addition to the work done for the 2005 Report and a 2006 supplement to that Report, all of which are available on the website for the Independent Sector, www.independentsector.org, that organization has also promulgated extensive recommendations on improving board governance, with the release in the fall of 2007 of a new publication, "Principles for Good Governance and Ethical Practice: A Guide for Charities and Foundations." All boards of charitable entities are strongly urged to review those documents for their recommendations.

E. Government Accounting Office (GAO) Position.

Shortly before the passage of the Sarbanes Oxley Act, in April 2002, the General Accounting Office (GAO), the investigative branch of Congress, reviewed the performance of the IRS, with regard to its ability to regulate the non-profit sector. The GAO report found that the IRS was not sufficiently staffed or funded to be able to adequately regulate the large number of non-profit entities in existence. The GAO reported that the number of non-profit organizations in 2000 numbered approximately 1.3 million. The IRS at that time did not have sufficient staff to regulate and review the sector adequately. The non-profit organizations have been increasing in number, while IRS staff had been decreasing over the same period. The vast majority of tax exempt organizations are charities, with their greater legal oversight requirements.

Since that time, the IRS has both increased its level of funding and staffing to properly regulate non-profit organizations. As a result, the degree of scrutiny of non-profits has increased. This has been shown both through investigations of non-profit organizations, as well as the development of new forms for Application for Recognition of Tax Exemption, Form 1023, and the annual information returns required to be filed by

organizations with revenue of $25,000 a year or more, Form 990. Beginning in tax year 2008, a much revised 990 form will ask for information covering many of the governance issues raised by the passage of the Sarbanes Oxley Act, now indirectly applicable to non-profit organizations.

Although much of this has been triggered by high profile scandals in both the for-profit and non-profit world, many of the requirements of Sarbanes Oxley are either already required by New Hampshire law, or have been slowly, in the past 4 years, included in IRS requirements. Specifically:

- Form 1023 now requires greater transparency and information on many aspects of an organization, including compensation of highly paid individuals. By law, Form 1023s are available for review by the public.

- Form 990: The information returns now ask for information on whether or not there are independent audits of a non-profit organization, how executive compensation is derived, fundraising expenses, document retention and destruction policies, whistleblower protections, and the public availability of Forms 1023 and 990 for each organization.

- IRS Publication 4221 – Compliance Guide for 501(c)(3) Tax Exempt Organizations: This publication, which provides a wide range of legal requirements in a convenient checklist for non-profit organizations, specifically requires that books and records relevant to tax exemption and filings with the IRS be retained, similar to the requirements for a taxpayer retaining its information.

- Single Audit and OMB Circular A-133: If an organization receives federal funds, it may be required to undergo one or more audits of its

financial statements, pursuant to the Federal “Single Audit Act” for the Office of Management and Budget (OMB) Circular A-133.

In addition, there are a number of state law requirements as well, that often provide, and have provided for many years prior to the Sarbanes Oxley, the same degree of transparency and public information now required of publicly traded corporations pursuant to the Sarbanes Oxley Act and recommended by the Panel on the Non-Profit Sector. These include:

- Annual reports to the New Hampshire Attorney General Charitable Trust Unit, including financial reports. RSA 7:28;

- Minimum number of “independent” directors for public charities. RSA 292:6-a;

- Prohibitions on self-dealing by officers, directors or trustees of non-profit charitable organizations. RSA 7:19-a;

- The requirement of a conflict of interest policy. RSA 7:19-a.

F. Tax Exempt Bonds.

The Sarbanes Oxley Act applies to “issuers” of publicly traded securities. As noted above, only a limited number of sections of the Act apply by their terms to non-profits. Even non-profits that do in fact “issue” securities such as tax exempt bonds are <u>not</u> covered by the other provisions of the Act because of specific exemptions for such organizations from federal securities law registration and reporting regulations.

However, although much of the Sarbanes Oxley Act is not explicitly applicable to non-profits, many of the good-governance principles of transparency, disclosure and independent bonds are being carried out by the IRS through indirect means. Many sections of the Act are relevant to larger non-profits. The 990's now will require information on many of the points required by Sarbanes Oxley for for-profit companies.

In addition, the IRS has begun distributing questionnaires to non-profit organizations that issue tax exempt bonds. The questionnaires are designed to elicit information on compliance with record-keeping and information reporting guidelines, post-issuance bond compliance, and compliance with the organizations' stated purposes. This is part of an effort to determine where such 501(c)(3) organizations are meeting their requirements for post-issuance tax compliance for their tax-exempt debt obligations. It appears the IRS will be sending questionnaires to about 200 such organizations who showed an outstanding balance on their tax year 2005 Form 990's.

G. Practical Considerations – Lessons Learned.

All of the discussions above involving the Sarbanes Oxley law, reports by the GAO and by the Panel on the Non-Profit Sector of Independent Sector to the Senate Finance Committee, as well as recent legislation in 2006, indicate that times are changing for charitable organizations. In many ways these changes are beneficial, by providing more guidance and requiring organizations to do a better job of describing the work that they do in their public filings. At the same time, the requirements are also becoming more burdensome for charitable organizations, especially small ones. The vast majority of charitable organizations have never had any financial misdealings or corruption by officials. Nevertheless, the high profile scandals, both in the business world and the non-profit world in the last 5 years, have raised concerns about the accuracy of financial information, and the role of independent boards governing non-profit organizations.

Charitable organizations are well-served by taking control of board governance, clear financial statements, and practical, effective operating procedures and disclosures. It is more important than ever before for organizations to make sure they are complying with the increasing requirements at both the state and federal levels for the disclosure of information. Organizations that fail to take responsibility on themselves may find it forced upon them, as the legal requirements tighten. Although there appears to be a lull in legislative activity at the state and federal levels in the current year, it is unlikely that this topic of scrutiny will remain out of focus permanently. In New Hampshire, we are fortunate to have excellent resources in the New Hampshire Attorney General's Office, both for guidance and for information, as well as for practical and compassionate oversight of charitable organizations.