

Urban Institute National Survey of Nonprofit Governance Preliminary Findings

Nonprofit Governance and the Sarbanes-Oxley Act

Francie Ostrower and Marla J. Bobowick

Making some of the Sarbanes-Oxley Act's provisions mandatory would require substantial numbers of nonprofits to alter their practices, but the passage of others would result in little change.

The Sarbanes-Oxley Act, passed in 2002 following widely publicized governance scandals at corporations such as Enron, was intended to deter fraud in publicly traded corporations. The Act extended boards' financial oversight responsibilities and imposed new financial disclosure requirements. Only two of these provisions applied to nonprofits. Its passage nonetheless quickly sparked discussions about nonprofit accountability and whether nonprofits should adhere to certain provisions of the Act, either on a voluntary or mandatory basis.¹

In 2004, for instance, the Senate Finance Committee issued a draft paper calling for stronger nonprofit governance, and various proposals continue to be debated. Several states have proposed or passed regulations that extend some provisions of the Sarbanes-Oxley Act to nonprofit organizations. For instance, the California Nonprofit Integrity Act of 2004 requires charities with gross revenues of \$2 million or more to have an audit committee. Some nonprofits have voluntarily adopted practices provided for by the Act. At the same time, efforts to extend provisions of the Act to nonprofits have been met with objections and concerns about the impact on smaller nonprofits.²

The recent Urban Institute *National Survey of Nonprofit Governance* provides new insights into the potential impact of extending some provisions of the Sarbanes-Oxley Act to nonprofit organizations.

Conducted in 2005, it is the first national, representative survey of nonprofit governance.³ The study gathered responses from 5,115 nonprofits of varied size, type, and location.⁴ This bulletin, which presents preliminary findings from one part of the survey, examines the current extent of nonprofits' adherence to some major Sarbanes-Oxley provisions and nonprofit leaders' perceptions about the ease or difficulty of compliance were similar provisions to become mandatory for nonprofits.⁵

How much of an impact would extending provisions of Sarbanes-Oxley to nonprofit organizations have? The answer suggested by the survey's preliminary findings is "it depends." Nonprofits' current adherence to Sarbanes-Oxley varies considerably for different provisions. Thus, making some of the Act's provisions mandatory for nonprofits would require substantial numbers of nonprofits to alter their practices, but the passage of others would result in little change because most nonprofits are already in voluntary compliance or because they must comply with other regulations that resemble Sarbanes-Oxley provisions.⁶

Adherence also differs markedly among nonprofits of different size (as measured by annual expenses). The differences between smaller and larger nonprofits are so pronounced that aggregate figures can be very misleading, and we therefore present findings separately for organizations in six different size categories, ranging from those with less than \$100,000 in expenses

up to those with over \$40 million (see appendix table). The results underscore the need for policymakers and others promoting good governance practices to keep the diversity of the nonprofit sector in mind, and to consider carefully the relevance and potential impact of proposed reforms on nonprofits of different size.

The Act's Provisions and Current Nonprofit Practice

Independent Audit Committee

The Act requires that the audit committee of publicly traded companies be responsible for appointing, compensating, and overseeing the auditor. The audit committee generally must include at least one financial expert,⁷ and may not include employees or other individuals who are paid by the organization for professional services.

Current nonprofit practice. A separate audit committee was the least

commonly adopted practice related to Sarbanes-Oxley issues in all size groups. Twenty percent of all nonprofits in the survey had a separate audit committee (figure 1). The practice was far more common among larger institutions, however, climbing from 15 percent among nonprofits with under \$100,000 in annual expenses to 58 percent among organizations with over \$40 million. It was only among nonprofits with over \$40 million that a majority of organizations had an audit committee. For most others, and even for many of the largest nonprofits, having a separate audit committee would represent a change in current practice.

Among nonprofits that did have an audit committee, however, the great majority included at least one financial expert on the committee. Most audit committees share one or more members with the finance committee, and 20 percent include paid staff.

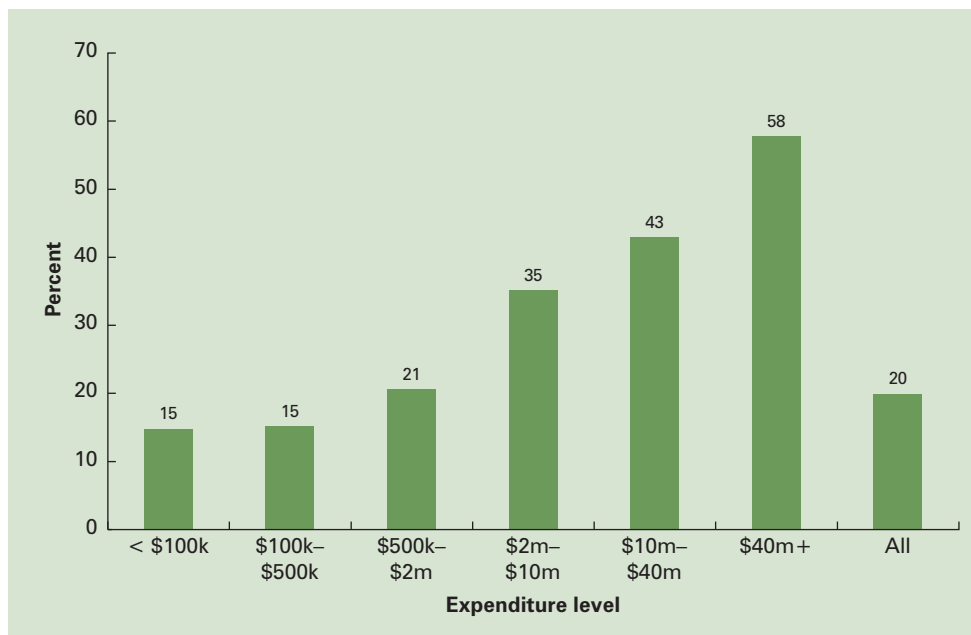
Most organizations with audit committees (54 percent) had created or revised the committee since 2002. The finding supports the idea that passage of the Sarbanes-Oxley Act spurred many nonprofits to reexamine and revise their practices.

Perceived difficulty of compliance. A slight majority (51 percent) of nonprofits that do not currently have an audit committee said it would be somewhat or very difficult for them to comply with a law requiring them to establish such a committee. Far fewer (19 percent) said it would be *very* difficult, but this sentiment was more common among smaller organizations. Among nonprofits with expenses of under \$100,000, fully 28 percent said it would be very difficult to comply, compared with fewer than 10 percent of nonprofits in any of the over \$2 million size groups.

A slight majority (54 percent) of those without audit committees also said it would be somewhat or very difficult to comply with a law requiring that a financial expert serve on audit committees, and 25 percent said it would be very difficult. Smaller organizations were once again more likely to characterize compliance as very difficult, with percents ranging from 35 percent among the smallest nonprofits to under 10 percent for nonprofits in all groups with expenses of over \$2 million.

Among respondents that *do* have a separate audit committee, 46 percent of those whose audit and finance committees share members said it would be somewhat or very difficult to comply with a law that required these two committees to have different members, but only 13 percent said it would be very difficult. Forty percent of those that include paid staff on the audit committee said it would be somewhat or very difficult to comply

FIGURE 1. Percent of Organizations with a Separate Audit Committee



Source: 2005 Urban Institute National Survey of Nonprofit Governance.

with a law prohibiting all staff from serving on the audit committee, and 21 percent said it would be very difficult.

Auditor Responsibilities

The Sarbanes-Oxley Act tries to ensure the independence of auditors. The Act calls for organizations to rotate their audit firms and/or lead partners every five years. Additionally, audit firms are generally prohibited from providing the organizations with other, non-audit services.⁸

Current nonprofit practice. Unlike publicly traded companies, nonprofits are not universally required to have an external audit—but most do.⁹ Sixty-seven percent of the nonprofits in the study had an external audit within the previous two years. That figure jumps to 91 percent for nonprofits with expenses of over \$500,000, and over 96 percent among nonprofits with ex-

penses greater than \$2 million. Still, a provision requiring an external audit would affect one-third of the sample members that had not had one during the past two years (figure 2).

Many nonprofits that did not have an audit had their financial statements compiled or reviewed by an outside certified professional accountant, a less costly option often used by smaller nonprofits. Forty-three percent of the smallest nonprofits had an outside audit, but the figure jumps to 70 percent if we also include those that had their financial statements compiled or reviewed by an outside certified public accountant. The combined figure is 89 percent for organizations in the next largest size category, and greater than 97 percent for organizations with expenses over \$2 million. Still, even with the combined figure, 30 percent of nonprofits with annual expenses under \$100,000 were not subject to an outside review.

Among those that did have an audit, the great majority also had the audit firm prepare their IRS Form 990, but far fewer (20 percent) had used the same firm for other services. Slightly more than half had used the same audit firm for five years or more, and of these, 58 percent had also used the same lead partner. In all, 28 percent of nonprofits that had an audit had used the same audit firm and lead partner for five years or more—something that would not be permitted if the Sarbanes-Oxley Act were applied to nonprofits.

Perceived difficulty of compliance. Among organizations that did not have an audit during the previous two years, 62 percent said it would be somewhat or very difficult to comply with a law requiring them to have one. A substantial minority (30 percent) said it would be *very* difficult.

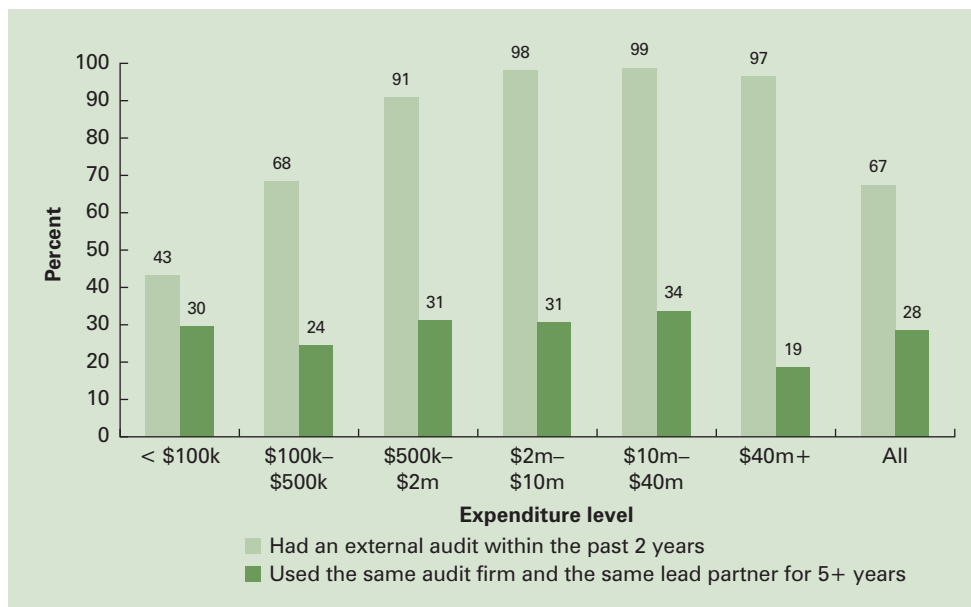
Among nonprofits that *did* have an audit and used the same audit firm and lead partner for five or more years, 64 percent said it would be somewhat or very difficult to comply with a law requiring that they rotate their audit firm and/or lead partner every five years. Twenty-one percent said it would be *very* difficult. The figure drops considerably among larger nonprofits: 30 percent of the smallest, compared with 7 percent of the largest, organizations said this would be very difficult.

Certified Financial Statements

Under the Sarbanes-Oxley Act, the chief executive and financial officers are responsible for certifying the accuracy of the organization's financial statements. The Act includes penalties for those who knowingly and intentionally violate this provision.

Current nonprofit practice. The CEO of 51 percent of all nonprofits

FIGURE 2. Percent of Organizations with an External Audit during the Past Two Years and Percent of These Audited Organizations that Used the Same Audit Firm and Lead Partner for Five or More Years



Source: 2005 Urban Institute National Survey of Nonprofit Governance.

studied signed the organization's IRS Form 990. The percentage was considerably lower (29 percent) among the very smallest nonprofits. Our data do not allow us to determine how many chief financial officers signed the IRS Form 990.

Perceived difficulty of compliance. Among respondents whose CEO does not sign the Form 990, only 13 percent said it would be somewhat or very difficult to comply with a law requiring that the CEO sign a declaration that he or she received reasonable assurance of the accuracy and completeness of the IRS Form 990. Four percent said it would be very difficult.

Disclosure

The Sarbanes-Oxley Act requires public companies to make disclosures regarding certain aspects of their finances and internal control mechanisms. Companies must also promptly disclose material changes in their operations and finances.

Current nonprofit practice. Among nonprofits that conducted audits, most (76 percent) reported that they make them publicly available. There was no consistent pattern by size. The percent was lowest (66 percent) among the smallest organizations, but ranged from 75 to 85 percent among other groups.

Nonprofit organizations are already legally required to make their IRS Form 990 returns available to the public. They are not required to post the return on their web site, but we were interested in how many disseminate their return by posting it on their web site or including a link to another site that posts it, such as GuideStar. Few apparently do—under 11 percent of organizations that have a web site posted the return or the link (the percent ranged from 7 among the small-

est to 15 percent among the largest institutions).

Insider Transactions and Conflicts of Interest

The Sarbanes-Oxley Act generally prohibits publicly traded companies from making loans to their directors or executives. It also requires that the company disclose whether it has adopted a code of ethics for senior officers (and if not, why not), as well as made any changes or granted waivers to its code of ethics.

Current nonprofit practice. It was very rare for nonprofits to make loans to board members—less than 1 percent of the organizations in any size group had made such loans.¹⁰ Fewer than 3 percent made loans to staff members, though the figure rises to between 6 and 8 percent among the larger organizations.

Fifty percent of nonprofits in the study had a conflict of interest policy for board members, but there is substantial variation by organizational size—ranging from 23 percent among the smallest organizations to 95 percent among the largest ones. As the appendix table indicates, substantial percentages of organizations in the smaller size categories did not have a written conflict of interest policy.

Of those that had a conflict of interest policy, 47 percent had created or revised the policy since 2002.¹¹

“Whistleblower” Protections

The so-called whistleblower provision is one of two provisions of the Act that applies to all organizations, including nonprofits. Sarbanes-Oxley makes it a federal crime for any entity to retaliate against employees who report suspected fraudulent financial activities.¹²

It also has a provision specifically requiring the audit committee to establish a process for employees to report accounting practices that they perceive as inappropriate, but this provision applies only to publicly traded companies.¹³ Two national nonprofit organizations—BoardSource, which focuses on nonprofit governance, and Independent Sector, a coalition of nonprofits and foundations—recommend that a whistleblower policy is one way to demonstrate an organization's compliance with this provision.

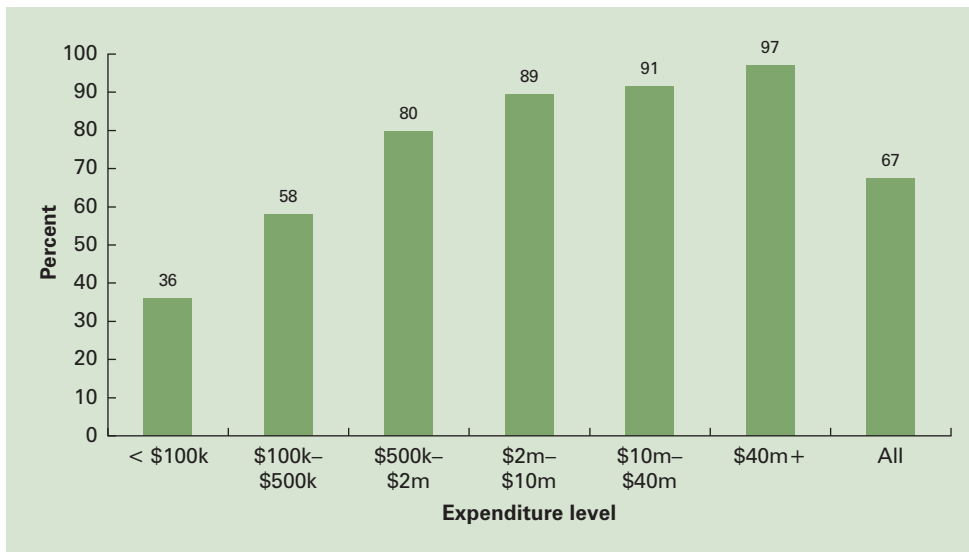
Current nonprofit practice.

Among nonprofits with at least one employee, 67 percent had a formal process for staff to report complaints without fear of retaliation (figure 3). The percentage of organizations with a process to protect whistleblowers rises among larger organizations. Among nonprofits with one or more employees, it rises from 36 percent among the smallest nonprofits to 97 percent among the largest organizations. The percentage of organizations with a process to protect whistleblowers is higher among nonprofits with at least two employees, starting at 57 percent among the smallest organizations and again rising to 97 percent (see appendix table). Among those that had a formal process to protect whistleblowers, 46 percent had created or revised the policy since 2002, another indication of the impact of the Act's passage on nonprofit institutions.

Document Destruction Policy

A second provision of the Sarbanes-Oxley Act that applies to all organizations makes it a federal crime to alter or destroy documents in order to prevent their use in an official proceeding.¹⁴ This provision does not specifically require organizations to have a written document retention and

FIGURE 3. Percent of Organizations with One or More Employees that Have a Formal Process for Employees to Report Complaints without Retaliation



Source: 2005 Urban Institute *National Survey of Nonprofit Governance*.

destruction policy. BoardSource and Independent Sector, however, advise that nonprofits should have a written policy because, with the Act's passage, organizations need to monitor and justify their document destruction procedures (BoardSource and Independent Sector 2003).

Current nonprofit practice. Thirty percent of nonprofits had a written document retention and destruction policy. The percentage was considerably higher among larger organizations, but even a substantial minority of the largest organizations (25 percent) had no written document retention and destruction policy (and fully 86 percent of nonprofits with under \$100,000 did not have a written policy).

Among nonprofits with a written policy, 47 percent had created or revised it since 2002. This certainly suggests that passage of the Act prompted many to reexamine and concretize their policies, and it is somewhat surprising that this was not the case for a larger number of organizations.

Implications

What would be the potential impact of extending Sarbanes-Oxley provisions to nonprofit organizations? Our preliminary findings suggest the answer is complex, and it is not the same for all provisions or for nonprofits of different size. For instance, since it was rare for any nonprofit to make loans to its directors, additional legislation prohibiting nonprofits from making such loans would impact comparatively few organizations. On the other hand, a law or best practice guideline calling for nonprofits to establish a separate and independent audit committee would have a widespread impact because most do not currently have such a committee. The impact would also differ by size—a greater percentage of small nonprofits would have to change in order to comply, and more small nonprofits believe it would be very difficult to comply. Our findings strongly confirm the importance of acknowledging the potentially different impact, cost, and value of applying provisions to nonprofits of

different size, as some laws and proposals already are, by excluding organizations below a certain size.

Whether legislators enact future regulations to extend Sarbanes-Oxley to nonprofits, the Act's passage has already profoundly influenced debate and discussion about the practice of nonprofit governance. Our findings therefore offer much for consideration by all concerned with promoting good governance practices, whatever the route—mandatory or voluntary—through which they seek to achieve their goals.

Notes

1. *Legal Times*, February 21, 2005. For summaries of the Sarbanes-Oxley Act and its relation to nonprofits, see, for instance, American Bar Association 2005 Coordinating Committee (2005); BoardSource and Independent Sector (2003); Fremont-Smith (2004); NACUBO Advisory Report 2003-3; Oxholm (2005); and Reiser (2004).
2. See, for instance, Fremont-Smith (2004), 435.
3. See Ostrower and Stone (forthcoming).
4. The response rate was 40.6 percent. The sample was drawn from the Urban Institute's 2002 NCCS-GuideStar National Nonprofit Research Database of public charities that file IRS Form 990. The sample was stratified by size, and figures in this brief are based on analyses weighted to adjust for differential probabilities of selection as well as nonresponse patterns.
5. The final findings and full survey analysis will be presented in the full Urban Institute survey report later this year.
6. Nonprofits may be required to comply with such regulations depending on such factors as what state they are in, whether they receive government funds, and whether they operate in a regulated industry. See Brody (2004) and Fremont-Smith (2004).
7. Or, if no financial expert is included, the organization must explain why not.
8. Certain other services—such as tax preparation—may be carried out with the pre-approval of the board's audit committee or if the other services' value is under 5 percent of

the amount paid for the audit (Sarbanes-Oxley Act 2002, Section 201).

9. Some states do require audited financial statements from nonprofits of a certain size or from nonprofits that solicit funds from the public (Fremont-Smith 2004, 458). Furthermore, the federal government also requires nonprofits that expend more than \$500,000 in federal awards to conduct an annual audit (OMB Circular A-133, Section 200).
10. Some states already have laws that prohibit nonprofits from making such loans.
11. In 2005, a question about whether the organization has a written conflict of interest policy was added to the IRS Form 990. Although there is no penalty for not having one, it will be interesting to see whether the inclusion of the question itself spurs additional nonprofits to create a written policy.
12. See Sarbanes-Oxley Act 2002, Section 806.

13. See Sarbanes-Oxley Act 2002, Section 301.
14. See Sarbanes-Oxley Act 2002, Section 1102.

References

- ABA Coordinating Committee on Nonprofit Governance. 2005. *Guide to Nonprofit Corporate Governance in the Wake of Sarbanes-Oxley*. Chicago, IL: American Bar Association.
- BoardSource and Independent Sector. 2003. *The Sarbanes-Oxley Act and Implications for Nonprofit Organizations*. <http://www.boardsource.org/clientfiles/sarbanes-oxley.pdf>.
- Brody, Evelyn. 2004. "Submission in Response to June 2004 Discussion Draft of the Senate Finance Committee Staff Regarding Proposed Reforms Affecting Tax-Exempt Organizations." <http://www.urban.org/url.cfm?ID=900747>
- Fremont-Smith, Marion. 2004. *Governing Nonprofit Organizations*. Cambridge, MA: Harvard University.
- NACUBO (National Association of College and University Business Officers). 2003. "The

Sarbanes-Oxley Act of 2002: Recommendations for Higher Education." Advisory Report 2003. Washington, DC: NACUBO.

- Office of Management and Budget (OMB). n.d. OMB Circular No. A-133. See §200 Audit Requirements. <http://www.whitehouse.gov/omb/circulars/a133/a133.html#top>.
- Ostrower, Francie, and Melissa Stone. Forthcoming. "Boards of Nonprofit Organizations: Research Trends, Findings, and Prospects for the Future." In *The Nonprofit Sector: A Research Handbook*, 2nd ed., edited by Walter W. Powell and Richard Steinberg. New Haven: Yale University Press.
- Oxholm, Carl III. 2005. "Sarbanes-Oxley in Higher Education: Bringing Corporate America's 'Best Practices' to Academia." *Journal of College and University Law* 31: 351-76.
- Reiser, Dana Brakman. 2004. "Enron.org: Why Sarbanes-Oxley Will Not Ensure Comprehensive Nonprofit Accountability." *UC Davis Law Review* 38: 205-80.
- Sarbanes-Oxley Act of 2002.

APPENDIX TABLE. Practices and Policies by Organizational Expenses (number and percent engaged in practice)

	< \$100k		\$100k–\$500k		\$500k–\$2m		\$2m–\$10m		\$10m–\$40m		Over \$40m		All	
	N	%	N	%	N	%	N	%	N	%	N	%	N	%
Have Separate Audit Committee	272	14.78	226	15.19	171	20.63	178	35.10	82	42.86	56	57.75	986	19.90
<i>Members include</i>														
Paid staff	16	5.81	48	21.43	44	26.07	48	27.53	30	36.49	10	19.03	196	20.17
Financial committee members	121	45.01	136	61.80	104	62.12	132	75.74	68	83.19	37	68.31	598	61.89
Financial expert	228	86.35	206	92.39	151	91.36	160	92.50	80	97.13	53	96.66	878	91.23
Audit Past Two Years	803	43.00	1,022	68.18	756	90.85	497	98.08	190	98.66	96	96.51	3,364	67.31
Board required to approve audit	504	63.85	755	75.43	643	86.57	451	91.82	177	94.77	89	95.40	2,620	79.26
Audit firm prepared 990	567	71.52	768	77.12	609	81.71	403	83.12	142	76.64	64	68.06	2,552	77.41
Audit firm performed other services	133	16.99	184	18.43	162	21.88	117	24.08	48	26.00	19	20.15	664	20.17
Make audited financials public	500	66.13	726	74.72	600	82.19	406	84.64	153	83.50	73	78.03	2,458	76.48
Same audit firm 5+ years	399	51.04	471	47.67	392	52.88	287	59.18	115	61.63	59	62.49	1,723	52.57
<i>Of these, same lead partner</i>														
5+ years	214	62.81	221	56.63	218	61.88	139	54.39	60	56.17	16	31.15	868	57.97
Audit or Outside CPA Review Past														
Two Years	1,277	70.41	1,322	89.34	808	97.86	504	99.71	191	99.57	97	97.24	4,200	85.42
Written Conflict of Interest Policy	423	23.21	748	50.77	592	72.14	428	85.58	177	92.04	94	95.19	2,462	50.16
Document Retention/ Destruction Policy	250	13.86	389	26.49	316	38.55	285	57.22	129	67.78	74	75.08	1,443	29.57
Whistleblower (All Organizations)	344	20.61	770	53.02	630	77.43	441	88.85	174	90.84	95	96.89	2,454	51.97
(1+ employees)	185	35.89	679	57.88	620	79.66	430	89.28	172	91.43	93	96.93	2,180	67.40
(2+ employees)	103	56.71	574	62.65	614	80.48	430	89.36	172	91.43	93	96.93	1,986	75.64
Loans to Board Members	10	0.53	4	0.27	7	0.82	1	0.24	0	0.03	0	0	22	0.44
CEO/Executive Director Signs														
IRS Form 990	520	28.92	784	53.93	575	71.10	391	79.07	133	70.10	57	58.07	2,460	50.80

Source: 2005 Urban Institute National Survey of Nonprofit Governance.

Notes: Table should be read as follows: 272 (or 14.78%) of nonprofits with expenses of under \$100,000 said they have a separate audit committee. Numbers based on weighted data. The base number on which percentages are calculated varies due to missing data.



THE URBAN INSTITUTE

2100 M Street, NW
Washington, DC 20037

Nonprofit Org.
U.S. Postage
PAID
Permit No. 8098
Ridgely, MD

Address Service Requested

For more information,
call Public Affairs:
202-261-5709
or visit our web site,
<http://www.urban.org>.
To order additional copies
of this publication, call
202-261-5687
or visit our online bookstore,
<http://www.uipress.org>.

THE URBAN INSTITUTE

2100 M Street, NW
Washington, DC 20037

Copyright © 2006

Phone: 202-833-7200

Fax: 202-467-5775

E-mail: pubs@ui.urban.org

BOARDSOURCE

1828 L Street NW, Suite 900
Washington, DC 20036

Phone: (202) 452-6262

Fax: (202) 452-6299

www.boardsource.org

The Urban Institute's Center on Nonprofits and Philanthropy conducts research on the nonprofit sector to inform decisionmakers in government, nonprofits, foundations, and business. Our mission is to create an objective picture of the nonprofit sector, advance transparency and accountability, and assess consequences of public policies on the sector through rigorous research. We facilitate dialogue on pressing issues by hosting policy briefings and by disseminating findings widely. Our publications are available on the Urban Institute web site, at <http://cnp.urban.org>.

Through the National Center for Charitable Statistics (NCCS) we create and maintain the National Nonprofit Data System, a research-quality datasource on the nonprofit sector. NCCS translates data on the sector's size, scope, and financial trends into accessible information for local, state, and national policymakers and provides data and technical assistance to scholars and the public. NCCS databases can be accessed at <http://nccs.urban.org>.

BoardSource increases the effectiveness of nonprofit organizations by strengthening boards of directors through our highly acclaimed consulting practice, publications, tools, and membership program. BoardSource provides resources to nonprofit leaders through workshops, training, and an extensive Web-based database; governance consultants who work directly with nonprofit leaders to design specialized solutions to meet an organization's needs; the most comprehensive selection of material on nonprofit governance, including a large selection of booklets, books, videotapes, and audiotapes; and an annual conference that brings together approximately 600 board members and chief executives of nonprofit organizations from around the world.

The views expressed are those of the authors and should not be attributed to the Urban Institute, its board, its sponsors, or other authors in this series. Permission is granted for reproduction of this file, with attribution to the Urban Institute.

The authors thank Elizabeth Boris, Evelyn Brody, and Outi Flynn for their comments. The Urban Institute Center on Nonprofits and Philanthropy is grateful for operating support from the following foundations: Atlantic Philanthropies, Inc., the Ford Foundation, the Bill & Melinda Gates Foundation, the William and Flora Hewlett Foundation, the W. K. Kellogg Foundation, the David and Lucile Packard Foundation, the Carnegie Corporation of New York, and others.