

**New York University Stern School of Business  
Vincent C. Ross Institute of Accounting Research**

**Forum on Corporate Governance of  
Not-for-Profit Organization**

**November 14, 2005**

The Sarbanes-Oxley Act [SOX] was signed into law in July 2002, following some of the most devastating corporate scandals in recent history. The Statute, which covers corporate governance, financial-reporting, record-keeping and Standards is intended to restore investor confidence in our financial markets and restore the tarnished image of corporate America. Although primarily directed to participants in financial markets (for-profits), awareness of SOX has surged in the not-for-profit (NPO) sector, leading to major changes in their corporate-governance policies. Large NPOs<sup>1</sup> have established independent directors, and audit committees that include a financial expert. They have improved their internal audit functions, and procedures for independent approval of related-party transactions and whistle-blower protection.

NPOs, by the nature of their activities, impact upon all members of society. There has always been an element of trust between the public and NPOs, based on perceptions of the inherent goodness of individuals who choose a career path in charitable institutions, education, and medicine. Career paths wherein the monetary rewards have historically been significantly below the financial sector. The altruistic nature of their endeavors is incompatible with a lack of trust. In general, the trust placed in these institutions has been well deserved. It is the classification of all tax-exempt organizations as NPOs, that may be responsible for misperceptions and thus the proposed legislation to require a modified version of SOX for all NPOs. NPOs contend that the requirement would add a substantial financial burden, and in some cases, literally, *“take the food out of the mouth of babes”*.

**November 14, 2005.** NYT Special Section: ***Giving*** *“What is Charity?”*  
*Nonprofits are richer than ever, but the share going to the poor continues to dwindle.*

Classifying all NPOs as an industry, and analysis of sector statistics, may lead to misinterpretation and a misunderstanding of the complexities of the world of nonprofits.

On **November 14, 2005**, the Vincent Ross Institute of the New York University Stern School of Business hosted a forum on *“Corporate Governance of Not-for-Profit Organizations”*. Dean Thomas Cooley (NYU) welcomed the distinguished panel and participants, representing the Office of the Attorney General, CEO and board members of NPOs, the accounting and legal professions, and academe. Seymour Jones (Associate

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<sup>1</sup> Approximately 90% of NPOs with revenues above \$300 million.

Director Ross Institute, Professor NYU Stern) set the stage for the discussions by noting that management was expending *public funds*, in both the for-profit and non-profit firms. In particular, recent catastrophic events have sparked inquiries into the allocation of donations. In lieu of the fact that the stakeholders were the “public”, various aspects of SOX may be applicable to NPO’s. Mark Lilling (Audit Committee Consulting Team) presented a review of the main provisions of SOX.

- Independent and competent audit committee with a requirement of one financial expert (publicly traded only)
- CEO and CFO must certify the financial statements (publicly traded only)
- Insider trader and conflict of interests policies (publicly traded only)
  
- Auditors attest to and report on the assessment of internal controls (publicly traded only)
- Whistle-blower protection (all entities, including NPO’s)
- Document retention (all entities, including NPO’s)

Mark Lilling, in his advisory capacity to boards of directors, has urged prudent organizations to be a step ahead of government regulators by implementing relevant aspects of SOX. The ideas of strong internal controls, independent board members and audit committees are all good business practices. Effective corporate governance also creates an atmosphere that attracts top management. Organizations receiving federal grants are already held to higher standards in compliance with governmental regulations, and are currently required to present reports on internal controls. Additionally, audit firms of NPO’s receiving government grants are required to undergo peer review wherein the quality controls and policies of the audit firm are scrutinized according to AICPA standards.

Teresa John (Professor, NYU Stern) provided the participants with a review and analysis of recent academic research on NPOs as follows:

- NPO boards are usually composed exclusively of volunteers motivated by interest and/or beliefs, rather than compensation.
- Similar to for-profit directors, there is a duty of loyalty (avoiding conflicts of interest) and a duty of oversight.
- Although the incentive for misstatement of financial reports is not present, similar to for-profit, scandals involve over-generous compensation and misuse/embezzlement of funds.
  
- 2004 for-profit CEO average pay package: \$10 million
- Percentage increase: 13% over 2003
- 2004 Median NPO-CEO pay: \$319,119
- Percentage increase: 3.7% (approximate rate of inflation)
  
- Cost of SOX: Revenues less than \$1 billion = \$3.4 million (annually)
- Audit fees in the for-profit sector rose between 55-92% in 2004.

- Federalization of corporate law is seen as a backdoor power grab of state authority.

Although compensation increases in NPOs were associated with increasing the ratios of program spending/revenues, government scrutiny (Senate Finance Committee, IRS) are frequently cited as a key reason for stagnant wages.

Gerald Rosenberg (Chief of the Charities Bureau, Office of the NYS Attorney General), shared the outcomes of the recent investigations<sup>2</sup> that have prompted action on the part of the Attorney General. The NYS Attorney General's office (AGO) supervises organizations and individuals that administer and/or solicit charitable funds in NYS. The Attorney General has broad authority to regulate NPOs and charitable trusts and to commence law-enforcement investigations and legal actions in the public interest. To better protect NPOs against fraud, the Attorney General has drafted a bill that would apply certain principles of the Sarbanes-Oxley Act to the NPO sector. The highlights include:

- Require the president and treasurer to certify to the accuracy of the annual report and the sufficiency of internal controls.
- Authorize the Attorney General to bring action for the removal of directors or officers for willful failure to file requisite reports.
- Require designation of an independent executive committee and audit committee for NPOs with revenues over \$250,000.
- Prohibit audit committee and board members from accepting compensation other than in their capacity as audit committee or board members.
- Executive compensation limitations.
- Require "whistleblower" procedures.

Michael Hayes (Partner, PricewaterhouseCoopers LLP) reviewed the existing and proposed state and federal legislation for NPOs, detailing and expanding upon the current need to implement the proposals of the OAG and adopt additional Sarbanes-like proposals. Mr. Hayes believes that a requirement for and external attestation by the independent auditor of a NFP organization under section 404 would be extremely costly, however he is a strong advocate of organization reviewing the "best practices" coming out of the SOX legislation. He believes organizations should review, update and/or establish conflict of interest policies, independent audit committees with a financial expert identified, whistle blower policies, board review of Form 990 prior to filing, board review of executive compensation and documentation of accounting policies, procedures and associated internal controls. These documents should be reviewed annually for applicability.

Barry K. Fingerhut (President and Board Member of FEGS, Principal, GeoCapital) is a prime example of the devotion, dedication, and altruistic nature of individuals who serve as board members of NPOs. The compensation they receive is in terms of the aesthetic rewards of serving society. As a board member of the largest

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<sup>2</sup> Confidentiality maintained where necessary.

Health and Human Services agency in NYC, Mr. Fingerhut is able to attest to the layer upon layer of regulation, internal controls, and audits that any agency receiving government funds is subjected to. The scrutiny is unparalleled in the for-profit sector. Increasing the already heavy burden of NPO's would ultimately lead to costs that outweigh the benefits thereof, diverting resources from the needy beneficiaries thereof. He cautioned that increasing the liability of volunteer board members will ultimately lead to a loss of leadership that society can ill afford.

Dr. Joel Levy's (C.E.O., YAI/National Institute for People with Disabilities) eloquent presentation of an "insider" view of large NPOs had the audience riveted and many heads nodding vigorously in agreement. He strongly disagreed with attempts to classify all NPOs as an homogeneous industry. NPOs differ in their diversity, complexity, funding, number of staff, and size. While charitable organizations are formed for a particular purpose (i.e.: a university, library, museum, or hospital) there is simultaneously a great diversity of operations across NPOs and a similarity across a variety of charitable organizations as they are all subject to the same tax codes and other statutory requirements. Government funded not-for-profits face much more stringent regulations than companies in the private sector. Agencies already compliant with government and board governance regulations have most of the checks and balances in place that SOX requires for for-profit entities and are under much greater scrutiny by the government. Because of the mandated government structures currently in place, a cost-benefit analysis does not justify additional legislation. Current audit reviews by government OF NPOS have no equal in the profit sector. One may argue that fiscal malfeasance in a charity is a violation of the public trust as compared to financial improprieties in the private sector. However, while one can never condone malfeasance in nonprofits, as a practical matter, such behavior while limited, pales in comparison to recent for-profit scandals. He affirmed the statements made by Mr. Fingerhut, that in the current environment NPOs are finding it increasingly more difficult to find board members.

James S. Sligar (Partner, Milbank, Tweed, Hadley & McCloy, board member N.Y. Community Trust) provided an overview of the existing Not-for-Profit Corporation Law (NPCL), which clearly spells out the duties of directors and board members of NPOs. They are comprehensive and already include guidelines in keeping with SOX. State statutes, although rooted in the common law, provide states with the authority to supervise and regulate NPOs under their jurisdiction. He cautioned that congressional hearings related to regulation of NPOs is a federalization of state authority. Participants were provided with a copy of the "*Current Corporate Governance Practices and Procedures*" employed by the N.Y. Community Trust. The document is comprehensive; including, but not limited to, issues related to conflict of interest, whistleblowers, audit committees, document retention, and conflicts of interest. Board members are required to sign a Conflict of Interest and Disclosure Statement.

*A fractured fraternity*-- "Fifteen years ago, we had a partner in our auditor, now we have an overseer"<sup>3</sup> Although many would agree that auditors' *fraternal advice* created

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<sup>3</sup> "A Fractured Fraternity" John Goff, CFO Magazine.

fertile ground for abuse, others disagree to a legislated chasm created between institutions existing for the benefit of society, and the beneficial provider of advice that is based on knowledge obtained as a result of the auditing engagement.

Members of the board have also been targets. Board members of NPOs, in general, serve without compensation. They are selected for their judgment, integrity, and understanding of the philanthropic needs of the organization. They agree to serve because of their dedication, beliefs, and altruism. This should not be forgotten. Although NPOs are not subject to a market-based performance analysis, they are subjected to ratings by independent agencies. The current financial data available on, e.g. [www.GuideStar.org](http://www.GuideStar.org), could be expanded. Increased disclosure on corporate governance policies and procedures will assist in directing donor donations. “Let the donor decide”.

Moderator, Seymour Jones provided a cogent summary recognizing the validity of arguments opposing major legislative reform, but underscored the need to maintain the good faith and trust of the public. Stakeholders, be they owners or donors, are entitled to full disclosure, strong internal controls, independence of judgments, and the assurance of honorable discharge of fiduciary duties. The NPO’s and the donors would benefit from adopting certain provisions of SOX. It is incumbent upon the organizations to respond.<sup>i</sup>

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<sup>i</sup> One of the outstanding and unique features of NYU forums is the integration of academe with members of the so-called “real world”. Academic research has no private agenda; it is non-partisan. Scholarly research provides the foundation upon which intellectual discourse can thrive. The forum provided an opportunity for interesting, educational, and stimulating exchange of ideas.