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SARBANES-OXLEY ACT
WHAT ARE ITS IMPLICATIONS FOR NONPROFIT ORGANIZATIONS

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A. Perceived need for Independent control.

1) Actions of those in control of Enron, WorldCom, Adelphia and Tyco and United Way transgressions.

2) Shareholders of Public Traded vs. Members of Nonprofit. Role of State Attorney General.

3) Sarbanes-Oxley adds 25 new corporate governance and account requirements for publicly traded entities. Eliot Spitzer of New York has taken steps in New York to introduce legislation to effectively impose Sarbanes-Oxley standards on larger nonprofits and to some degree on all.

4) Role of the IRS Treasury has indicated it will consider periodic examination of tax exempt by way of requiring reapplication. Look for presence of:

5) Prohibition of insider transactions and conflicts of interest.

6) Independent and competent audit committee.

7) Certification of financials, 990 - 990T.

8) Full disclosure in financial statement.

9) Whistle blower protection.

10) Document retention.

11) Management assessment of internal controls.

12) Use of audit committee and expertise.

B. Sarbanes-Oxley direct Association application.

1) Whistle blower protection.

2) Record retention policy.

C. Sarbanes-Oxley indirect influence.

D. Director fiduciary obligations.

1) To act as a reasonably prudent person in protecting the Members' Interests and the assets of the Association (conflict of interest, preserve confidentiality, "wearing two hats").

2) Duty to become educated.

E. Fiduciary Obligations

1) The Directors of a Corporation, whether a profit or nonprofit, owe certain fiduciary duties to the Corporation and its shareholders or members. Directors of a corporate entity have authority to act on behalf of the entity; they also have an obligation to act in the best interest of the Corporation and to manage its affairs with the same care, diligence and prudence that they would use to manage their own business. This is a succinct description of the fiduciary obligation of the Directors of all Corporation. The duty covers Directors or governance bodies of any entity based on the position of an entity's Directors as being in control of the entity's assets and operations.

2) The fiduciary duty of a Director generally requires the Director to act in good faith with the care an ordinary prudent person in a like position would exercise under similar circumstances and in a manner the Director reasonably believes to be in the best interests of the Corporation. The Director has a duty of loyalty, duty of care and duty of obedience.

3) Within the area of fiduciary obligation, one area where current events have focused financial scrutiny on how Directors discharge their duties is the area of executive compensation.

Underwriters of D & O policies are now looking to the reasonableness of the total package provided Association executives in pricing D & O coverage and Directors' E & O coverage.

4) Compensation includes not only cash payments to the executive for services but also includes insurance, deferred compensation, automobile allowances, club memberships and other perquisites.

5) The business judgment rule applies when the Board of Directors act in setting the executive's compensation. For compensation to be excessive it must be shown that no person of ordinary sound business judgment would say that the consideration received was a fair exchange for the compensation paid.

6) In determining the reasonableness of compensation, courts will generally look at many issues to determine if the executive was paid in accordance with the executive's ability, services and time devoted to the entity, difficulties involved, responsibilities assumed, success achieved and increase in the revenues received by the entity.

7) For Section 501(c)(3) and (c)(4) entities, Section 4958 of the Internal Revenue Code establishes an excise tax (an "intermediate sanction") the IRS may impose as a sanction in cases where their executives are excessively compensated. Guidelines of importance in analyzing the imposition of the excise tax:

(a) Related Board Members should not participate in the setting of the executives' compensation.

(b) Use of comparative data to determine the fairness of compensation for functionally comparable positions.

(c) The Board should adequately document the basis for its compensation determination. All documentation must be completed contemporaneously with the setting of compensation.

Taking advantage of these standards results in a rebuttable presumption of reasonableness of the compensation set for the nonprofit executive. The IRS will attempt to rebut such a presumption by showing sufficient contrary evidence demeaning the value of the comparable data relied on by the Board of Directors of the entity.

The individual receiving the excess benefits is likewise subject to a tax of 25 percent of the excess benefit and an additional tax of 200 percent of the excess benefit if it is not corrected within the taxable period in which it is received.

8) A Director may not usurp an opportunity available to the corporate entity for the Director's own behalf. The law sets up crucial standards for transactions between a Director and his or her corporate entity. It is imperative that the Directors avoid any appearance of being in a conflict of interest with the entity. Such conflicts generally arise in dealing with persons or firms supplying goods or services to the Association, persons and firms from whom the Association leases property and equipment; persons and firms with whom the Association deals or is planning to deal in connection with the purchase of assets or services; other Associations or agencies or organizations and Associations which affect the operations of the Association.

9) Recently, Associations have been given to the adoption of internal regulations which delineate the responsibility of the Association's Directors to not take advantage of internally developed programs or other intellectual property of the Association which might not otherwise be protected by copyright or trademark. Such regulations are really nothing more than a statement of the legal obligations of Association Directors.

10) In furtherance of Directors' fiduciary obligations, the Board should have a written conflict of interest policy providing for (a) disclosure; if a Director believes that he or she may be perceived to have a conflict of interest; (b) abstention; an interested Director should not participate in discussion or voting with respect to a conflicted matter; (c) fairness; the transaction must be fair and reasonable from the Association's perspective.

Eventually, either states Attorney Generals or the IRS will be examining these issues under a Sarbanes-Oxley format to determine whether tax exempt status should be retained

F. Financial oversight.

1) Financial management is of equal importance to the nonprofit association environment as it is to the publically traded corporations now subject to the Sarbanes-Oxley Act of 2002. The only real difference between the public traded entities and our Association clientele is the difference of focus, governance of the entity and notoriety of questionable activity.

2) The legal restraints on the financial management of Association affairs is dictated by State law, federal statutes such as the Internal Revenue Code and by inference to publically developed standards such as those in the Sarbanes-Oxley Act.

3) The Sarbanes-Oxley Act of 2002 establishes a number of provisions relating to publically traded companies. These provisions do not directly pertain to tax exempt organizations. They do, however, as noted, establish a sense of oversight and accountability of any entity whose operations directly affect the financial well being of its contributors. Since trade tax exempt organizations are funded by their members or contributors who look to the organization to further their best interests, while being a future financial success, we will find, in the future, that the Sarbanes-Oxley standards will become increasingly important as a generic in judging the financial integrity of the organization acting in a fiduciary capacity to its contributors.

(a) The role of the Board of Directors and the need for an audit or other independent oversight committee. Historically, the role of the Association's Board of Directors in exercising its obligation of reviewing the annual financial statements was to try to not ask too many dumb questions. Now the Directors must satisfy themselves the statements accurately and fairly present the total

financial picture of the entity. This exacerbates the use of an audit committee of those knowledgeable to ask the smart questions to cover the liability of the Directors to surface accounting issues.

(b) For most nonprofit organizations, whether trade association or charitable entity, the Board of Directors usually serves as the organization's audit committee. In a directorship corporation in Michigan, the Board of Directors is the only voting body governing the organization. Since Enron, consideration of a nonprofit audit committee has become a hot topic among the commentators and such committees have been given added emphasis by the enactment of the Sarbanes-Oxley Act. Sarbanes-Oxley's emphasis to the recognition of Generally Accepted Accounting Principles, Generally Accepted Audit Standards and the fact that entities subject to its jurisdiction must have adequate internal controls and utilize GAAP or a reconciliation to GAAP in reporting to the organization's constituents.

(c) The audit committee must be comprised of individuals who are independent of the Association and must contain one individual who has adequate financial expertise.

4) The audit committee under Sarbanes-Oxley is responsible for the appointment, compensation and oversight of the work of the Company's auditor. The audit committee is responsible for enforcing the disclosure of any inappropriate activity on the part of organization's insiders and for the reporting by the organization to its appropriate constituents. It is particular importance to note that Section 209 of Sarbanes-Oxley states that State regulators are directed to make an independent determination as to whether its accounting oversight board standards shall be applied to small and mid-size nonregistered accounting firms. The standards that the oversight board will develop will therefore have bearing on small and midsize nonregistered accounting firms at a state and local level. This will more directly affect nonprofit entities whose financial statements are compiled or reviewed by a local CPA firm.

5) Generally, the responsibility of an audit committee is to oversee the audit of the organization's books and records and to ascertain the sufficiency and accuracy of a system of internal controls established by the organization.

6) Another important result of the use of an audit committee is the assurance that it affords that the Directors of the organization are adhering to their fiduciary duties to safeguard the financial condition of the organization and that the internal controls required to safeguard reported financial information are in place.

(a) In fulfillment of its obligations, the nonprofit audit committee should:

- Review the organization's annual audit report (annual financial statements and related footnotes) with the auditor in addition to the auditor's management letter.

- Review the scope of the audit or the scope of the outside accountant's services to the organization. This task must include analysis of the major risk factors faced by the organization and a determination that the internal controls for the organization are adequately met.

- Review any proposed changes in methods of accounting for the organization.

- Review with the outside auditor the quality of the organization's internal accounting and the accounting principles followed by the organization.

- Ascertain the outside auditors are sufficiently independent and that any collateral financial management work is performed by an unrelated accountant. Should the outside auditors be periodically changed. Should the audit partner with the Association's independent auditor be periodically changed.

- Ascertain appropriate levels of materiality with regard to financial statement reporting.

- Ascertain that all transactions between the entity and its executive employees are at arms-length and do not have a material impact on the financial statements of the entity.

(b) Independent of the outside auditor, ascertain the competency of the auditor, the make-up of the audit committee and that safeguards are in place to assume that the standards set forth in regulations such as Sarbanes-Oxley are being met.

G. What should an audit committee ask of the entry and/or its outside auditors?

1) How would you compare the quality of our finance department with other organizations with which you work?

2) What is your materiality threshold?

3) Do we have any unconsolidated entities such as foundation, taxable subsidiary, real estate holding company, joint venture or political action committee?

4) What is our exposure to taxes?

5) Do our investments conform to our investment policy?

6) How are pledges receivable recorded?

7) Is the receivable from our affiliate collectible?

8) Are our reserves adequate?

9) Does any one member, customer, donor or small group represent a substantial portion of our revenue.

10) Are we in compliance with loan covenants?

11) Are restricted contributions consistent with the donor's intent?

12) What happens if improprieties or illegal activities are uncovered?

If the organization does not utilize a separate audit committee, the Board should take the time necessary to address these questions and any other questions pertaining to financial management of the organization (i.e. are our internal controls adequate). In this way when a problem does surface, the Board of Directors of the organization will have at least discharged its fiduciary obligation to find out. Actions taken by a Board of Directors based on the "business judgment rule" will withstand challenges by disgruntled members when the organization falls upon turmoil or dissension over actions by the Board of Directors.

H. Ethical Considerations.

While it may be more difficult to assess money damages against Directors of nonprofit entities, in light of recent cases and the general concern over corporate governance fostered by Enron and its progeny, the ethical conduct of the officers of a nonprofit is an issue that will, in the future, be given more attention. Willful misconduct is increasingly measured by the ethical standards the Board of Directors requires of its officers and employees in the discharge of their functions. A Board of Directors may adopt a standard of ethical conduct of the highest degree. If, however, the Association's officers are allowed to operate in questionable unethical manners, the Association's Directors will be subject to liability exposure as to their lack of oversight and governance. What may nonprofit Directors do to infuse a proper standard of ethics?

1) Adopt and distribute a Code of Ethics.

2) Have employee guides reviewed by outside advisors.

3) Adopt an internal review process insuring compliance with a code of ethics.

4) Establish procedures for reporting unethical conduct which is periodically audited.

5) Appoint an officer with responsibility for overseeing and monitoring compliance.

6) Other methods of legally challenging the actions of a nonprofit Board of Directors:

(a) The Board of Directors of a nonprofit corporation are subject to the provisions of its Bylaws as are the Boards of any Corporation. If the Board of Directors improperly meet, any action from such a meeting is voidable by any other Director not notified or in attendance at the meeting. Please note, however, that others may not avoid actions from an improperly called Board meeting. Also actions taken at such a meeting may be ratified at a subsequent properly called and constituted meeting.

(b) If a Board of Directors acts improperly, its actions may be challenged by members of the organization or the State's attorney general.

(c) If the Board of Directors ignore the Bylaw provisions of the entity as to the governance of the entity and are members of the organization, a piercing of the corporate veil theory may be applied to hold that the entity was operating as an alter ego of the individual Directors in question who may be found personally liable for the consequences of their conduct which generally means they must pay the corporate liability themselves without indemnification.

(d) Role of State Regulators, Sarbanes-Oxley Section 209 and the responsibility of the auditor.

I) State Action.

1) Thirteen (13) states have taken some form of action - not Michigan as of yet.

2) States are segregating between larger nonprofits ($3,000,000 assets or $1,000,000 gross). Larger - CFO/CEO must do a Sarbanes-Oxley certification.

3) Separate audit committee.

4) Complaints must be forwarded to the Attorney General.

5) Board must approve executive compensation.

6) Conflict of interest standards on a par with intermediate sanction safe harbor provisions of the IRC - adequate documentation.

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