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Sarbanes-Oxley and Social Clubs and Other Tax-Exempt Organizations

By James J. Reilly

MARCH 2005 - The Sarbanes-Oxley Act of 2002 (SOA) established the Public Company Accounting Oversight Board (PCAOB) "to protect the interests of investors and further the public interest in the preparation of informative, accurate and independent audit reports for companies the securities of which are sold to, and held by and for, public investors." Even though the emphasis of SOA is on investor protection, there has been speculation and discussion about the applicability of SOA to tax-exempt organizations, including tax-exempt social clubs.

Why Sarbanes-Oxley?

The accounting irregularities at companies like Enron, Adelphia, and WorldCom appear to have been at least partially prompted by greed. Executives typically receive stock options as part of a compensation package and profit handsomely if the company's stock appreciates. But the profit motive can create enormous pressure on executives to report good financial results, thus increasing the company's share price and providing them with handsome financial rewards. Because compensation is not based on the appreciation of an organization's stock price, this motivation simply does not exist for the executives of tax-exempt organizations, including social clubs. And with the exception of whistleblower protection and record-retention rules, the mandate of the SOA does not extend to organizations that are not subject to securities laws, including tax-exempt social clubs.

How SOA does or might affect tax-exempt organizations has been much discussed. Officers and directors of tax-exempt social clubs, who typically serve in a voluntary capacity, are often officers, directors, or professional advisors to publicly traded companies, where SOA compliance is essential. Because SOA is central to the management of publicly traded companies, it is reasonable for such officers and directors to consider its application to social clubs. Second, certain articles, speeches, and continuing education programs have confusingly discussed SOA and tax-exempt organizations. Third, some commentators believe that certain provisions of SOA *should* apply to not-for-profits, including social clubs.

SOA Influence on Social Clubs

Not only does SOA generally not apply to tax-exempt organizations, forcing many SOA provisions upon them is simply impossible. For example, many SOA provisions, including those related to insider trading, disclosures of management stock transactions, analyst conflicts of interest, and appearances before the SEC, are not meaningful to tax-exempt organizations. Yet, some important SOA provisions could be modified for the corporate governance of tax-exempt organizations, including social clubs, such as the following:

Audit committee. SOA requires that public companies establish an audit committee. An audit committee can serve a useful role in the governance of a tax-exempt organization. This concept was

widely discussed many years before SOA. Typically, audit committee members at clubs are uncompensated volunteers, and it is advisable for audit committee members to receive no consulting or advisory fees from the social club. The audit committee's responsibilities include acting as the liaison to the club's external auditing firm, in which capacity the committee would review the social club's audited financial statements with the auditors to determine whether the statements are consistent with the audit committee's understanding of the club's financial position. The audit committee should also ensure that proper internal controls are in place, and review the management letter issued by the auditing firm. An audit committee may undertake other functions, and should be empowered to study or investigate any matter of interest that the audit committee believes may affect the quality of the financial statements.

In many small not-for-profits, including social clubs, the board of directors may be limited in size and the entire board may, in effect, function as the audit committee. Members of the board at a social club are usually financially literate, and generally at least one member of the board or audit committee is a financial expert (e.g., CPA, CFO, controller).

Internal controls. The internal control structure should be designed to disclose material information to the tax-exempt organization's officers, directors, and key employees. Properly functioning internal controls assist a social club's management and board in obtaining accurate and reliable accounting information, protecting the club's assets against fraud, ascertaining compliance with established policies and procedures, and evaluating the performance of various operating areas (e.g., golf course, tennis courts, dining room).

SOA addresses internal controls and requires that the management of public companies establish and maintain an adequate internal control structure. This should not be a new concept for exempt organizations; internal controls have always been key.

Internal controls are considered in connection with a club's annual audit, but given the heightened emphasis on internal controls in SOA, a social club may want a periodic in-depth analysis. A free source of helpful information, "Internal Controls and Financial Accountability for Not-for-Profit Boards from the New York State Charities Bureau," is available at www.oag.state.ny.us/charities /charities.html. This website also offers the free publication "Right From the Start: Responsibilities of Directors and Officers of Not-for-Profit Corporations." Both deal exclusively with not-for-profit organizations, and although not specifically addressed to social clubs, they contain meaningful discussions of internal controls and the duties of boards of directors of exempt organizations.

Conflict-of-interest policy. SOA calls for enhanced conflict-of-interest provisions and a code of ethics to promote honest and ethical conduct, ethical handling of conflicts of interest between personal and professional relationships, and full, fair, accurate, and timely disclosures.

In some respects SOA is simply catching up to not-for-profit tax law. Social clubs are subject to conflict-of-interest provisions in federal tax law. The statutory tax-law provision that establishes tax-exempt social clubs consists of three requirements, one being a prohibition against private inurement. Although private inurement is difficult to define precisely, in this context it can generally be thought of as forbidding the transfer of assets or income from a tax-exempt social club to an officer, director, or employee for a purpose inconsistent with the club's exempt function. Common examples include engaging in unreasonable business activities with members or paying unreasonable compensation to management.

Even with the prohibition against private inurement, a club may want to adopt a written conflict-of-interest policy. An excellent discussion of such policies for not-for-profit organizations is in *How To Manage Conflicts of Interest; A Guide for Nonprofit Boards*, by Daniel L. Kurtz (National Center for Nonprofit Boards, 1995).

Prohibition of loans. Once again, this is a case of SOA catching up to not-for-profit law. SOA prohibits extending personal loans to officers or directors of publicly traded companies. This is sound policy and is advisable for all tax-exempt organizations. New York State Not-for-Profit Corporation Law (NPCL) section 716 provides, in part, that "[n]o loans … shall be made by a [not-for-profit] corporation to its directors or officers."

Audit partner rotation. A tremendous amount of misinformation about this provision exists. SOA does not require or promote audit firm rotation. For publicly traded companies, SOA limits the involvement of the lead audit partner to five years. Considering that the volunteer officers and directors of a social club are routinely changing, it may be imprudent for the lead auditor to change every five years as well. Such organizations benefit from the consistent advice of a qualified professional. Audit partner rotation does not appear to serve the public interest and creates additional costs with no corresponding benefit.

Separate audit and consulting providers. SOA prohibits auditors of publicly traded companies from providing certain other services, including bookkeeping, financial systems design and implementation, internal audit outsourcing services, and legal services. Not-for-profit organizations, including social clubs, would be wise to use auditing firms that have adopted such policies.

Limited Applicability

Whistleblower protection. Two sections of SOA provide what is commonly referred to as whistleblower protection. One section provides protection to all organizations; the other section provides protection only to public companies. The provision that applies to all organizations, including social clubs, makes it a crime when someone "knowingly, with the intent to retaliate, takes action harmful to any person … for providing to a law enforcement officer any truthful information relating to the commission of any Federal offense." Not-for-profit organizations should establish a confidential procedure to receive and act on complaints concerning illegal or improper conduct.

Record retention. Two sections of SOA involving the destruction of, or tampering with, records in connection with a matter subject to a federal investigation or official proceeding, apply to all organizations. One section makes it a crime when someone "knowingly alters, destroys, mutilates, conceals, covers up, falsifies or makes a false entry in any record, document or tangible object with the intent to impede, obstruct, or influence the investigation or proper administration of any matter within the jurisdiction of any [U.S.] department or agency." The other section makes it a crime when someone "corruptly—(1) alters, destroys, mutilates, or conceals a record, document, or other object…with the intent to impair the object's integrity or availability for use in an official proceeding; or (2) otherwise obstructs, influences, or impedes an official proceeding." An appropriate record-retention policy must be established.

Senate Finance Committee. On June 22, 2004, prior to Senate Finance Committee hearings on a range of issues relating to the governance of exempt organizations, the committee staff released a discussion draft containing proposed reforms to the federal law of exempt organizations, still a work in progress. Some states' attorneys general and legislators have proposed legislation to strengthen governance of

not-for-profits. The committee draft discusses the following:

- A five-year review of the IRS's recognition of an organization's tax-exempt status;
- Improvement in the quality and scope of the IRS Form 990, Return of Organizations Exempt from Income Tax;
- A declaration by the CEO that such officer has put in place processes and procedures to ensure that the organization's Form 990 complies with the IRC;
- Increased penalties for failure to file complete accurate and timely Form 990s;
- The attachment of an auditor's report to the Form 990;
- Auditor rotation;
- Enhanced disclosure of insider transactions;
- Strong governance practices; and
- Limitations on board size.

Strong Effective Governance

The IRS should be commended for its work to ensure that exempt organizations, including social clubs, are acting in a manner consistent with their exempt purposes. Form 990 provides information annually that assists the IRS in determining compliance with the tax laws governing exempt organizations, as well as determining qualification for tax-exempt status. Before the Senate Finance Committee issued its draft, the IRS was already working to improve the Form 990 to provide better disclosure. The idea of encouraging strong corporate governance is also welcomed, and a conflict-of-interest policy is a sound idea. The Senate Finance Committee's suggestion that audit firms be retained for only five years may harm exempt organizations, including social clubs, because of increased start-up costs and the loss of institutional knowledge obtained through successive audits; it should be remembered that Congress did not adopt audit firm rotation for public companies as part of SOA.

At this point, it should be emphasized that SOA focuses on investor protection. Many provisions simply cannot be modified to apply to not-for-profit organizations, but certain provisions can be modified so as to strengthen the governance of exempt organizations, including social clubs. This is a good thing. Strong, effective corporate governance in the not-for-profit community is essential, and SOA is one of many sources to consider.

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