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Applying Sarbanes-Oxley Principles to Colleges and Universities

By Sean Goins, Don E. Giacomino, and Michael D. Akers

In the wake of the financial scandals that have occurred in the corporate sector, the public is demanding more accountability not only from corporations but also from nonprofit organizations such as universities. Boards of trustees report more concerns about the proper accounting for the use of resources. Institutions can enhance corporate governance by implementing some of the principles and procedures the Sarbanes-Oxley Act of 2002 (SOX) have mandated for public companies. Because public accounting firms audit universities, the firms can provide a valuable service to such clients by recommending ways in which universities can implement SOX practices that are appropriate and applicable.

SOX and NACUBO

Since the passage of SOX more than six years ago, much of the press and research have focused on the challenges and costs of implementing the act. Even with the difficulties, as of 2008 many large public companies have successfully complied with the requirements of SOX and now, along with investors and regulators, are becoming better acquainted with its benefits. SOX was once widely regarded as a compliance burden for public companies. Today, both public and private companies are increasingly viewing SOX compliance as a corporate governance best practice, with a quantifiable return on investment. As yet, many smaller private businesses and not-for-profit organizations have taken a backseat approach, letting larger public companies work out the kinks in implementation. Now that the challenges of implementation have been refined, smaller organizations are considering implementing SOX.

The National Association of College and University Business Officers (NACUBO) released an advisory report, "Consideration of Sarbanes-Oxley Guidelines and Applicability at Colleges and Universities" (2003). The report suggests that colleges and universities consider SOX "as a framework to help evaluate overall financial risks and not simply comply with accountability concepts that stem from structures and circumstances that differ fundamentally from the stewardship responsibilities and public obligations they face." The format suggested in the NACUBO report is illustrated in the following example:

Section Title: 20. Services outside the scope of practice of auditors.

Description: Makes it unlawful for a registered public accounting firm to contemporaneously perform both audit and non-audit services.

Recommended Actions: Draft a Charter for the Audit Committee (AC). AC charter will indicate AC's role to ensure prohibited non-audit services are not performed by external auditor.

Benefits for Colleges and Universities

PricewaterhouseCoopers has stated that private companies' motivation to embrace SOX principles may be to show the public that they are forward-looking. "By voluntarily embracing aspects of mandated behavior for public companies, they are using regulation and oversight as a means to an end, better positioning themselves for a future IPO or to be acquired by a public company," said Michael Petrecca, a PricewaterhouseCoopers private company services partner. If this is the reasoning for larger private companies, then what are the benefits for colleges and universities that will never go public? For starters, many colleges and universities, along with other nonprofits, have established best practices which they adopt when they think they will derive some benefit. For instance, a college or university may decide that a whistleblowing policy is of high benefit with low costs; thus, it may comply with section 806 of SOX. A forthcoming article ("An Empirical Examination of Whistle-blowing Policies and Mechanisms at Universities," in the *Journal of Forensic Accounting*) finds that 48% of the responding universities had developed both a whistleblower policy and reporting mechanisms. An increasing number of nonpublic companies and nonprofit organizations are implementing sections of SOX because they believe it will benefit their organizations without dramatically increasing their costs. It would be unsuitable for colleges and universities to comply with the entire act, but implementing best practices among the SOX provisions allows colleges and universities to improve their financial reporting, corporate governance, and internal controls.

SOX, with limited exceptions, applies only to publicly traded companies, their executives, and their auditors. The 2003 report by NACUBO indicates that colleges and universities, however, may be indirectly affected in the following ways:

- Closer scrutiny and questioning of institutional transactions and relationships by board members sensitized to a new environment of corporate responsibility in general, as well as the obligations of trustees in particular;
- More vigilant enforcement and oversight by state agencies, the Internal Revenue Service, and other regulatory entities with jurisdiction over financial integrity and other aspects of nonprofit organizations;
- Increased citation of SOX provisions as models for future nonprofit legislation and for standards of fiduciary conduct; and
- More rigorous review of transactions and financial statements by institutional auditors, and heightened oversight of and restrictions on auditors themselves.

Martin Michaelson wrote about the important decisions that education institutions now face regarding whether or not Sarbanes-Oxley principles are appropriate for them ("The Significance of Sarbanes-Oxley for College and University Boards," *Trusteeship*, vol. 13, no. 3, May/June 2005). Michaelson discussed the advantages and disadvantages of implementing SOX provisions at colleges and universities. He cautions readers that, while some aspects of business governance may be helpful to college and university boards, generalities about best business practices or copying other institutions' plans are not enough. In considering this change, trustees must refer to the specific institution.

Corporate scandals such as Enron were responsible for bringing about the Sarbanes-Oxley Act. However, even universities are not immune from scandals. Any type of organization can benefit from implementing the relevant sections of SOX. In his article "Universities can apply lessons from Sarbanes-Oxley standards," (*Kansas City Business Journal*, July 16, 2004), John Mattie observed:

> What does this mean for colleges and universities? And how can these institutions benefit from the measures to enhance accountability that are being put in place in the corporate world? On balance, institutions can make use of Sarbanes' principles and certain provisions to help maintain the confidence of stakeholders, such as alumni donors, bondholders, and the foundations and government agencies that provide significant financing.

Implementing best practices among the SOX provisions allows colleges and universities to improve their financial reporting, corporate governance, and internal controls.

Universities Implementing SOX

Although SOX does not currently apply to colleges and universities, it has created a climate in which many colleges and universities are considering ways to increase transparency and accountability in their financial operations. As Michaelson (2005) pointed out, 85% of all governing boards have reported discussing the statute as it might apply to their college or university.

Gene Smith surveyed senior business officers at universities and colleges as to whether they agree or disagree with implementation of SOX. Smith's study yielded the following results ["Should the Requirements of the Sarbanes-Oxley Act of 2002 (SOX) Be Applicable for Universities and Colleges?" *Journal of International Management Studies*, vol. 1, July 2006]:

- 51.5% of respondents strongly or moderately disagreed with implementing SOX.
- 52.5% of respondents agreed or strongly agreed with implementing selected sections of SOX.
- 51.6% of respondents agreed or strongly agreed that section 103 should be mandated, if sections of SOX are mandated.
- 50.4% of respondents agreed or strongly agreed that section 204 should be mandated, if sections of SOX are mandated.

PricewaterhouseCoopers' report "Taking the Right Path" provides details on the results of the Sarbanes Summit underwritten by the firm. The summit brought together university presidents and business officers to discuss and make recommendations about governance, internal controls, certification of financial statements, and enterprise risk management. During the summit, the results of a NACUBO survey of member institutions designed to determine current and planned governance and senior management Sarbanes-related practices were reported. The survey found that most public and private institutions have separate audit committees. The committees have at least one member as a financial expert and charters that delineate their responsibilities, are involved in selecting the external auditor, and oversee the annual audit. Regarding internal controls, the survey found that managers at many public institutions already deliver internal control reports to the audit committee. Responses to one of the questions on internal control, however, indicated that neither public nor private institutions would be prepared if an assessment of internal controls was required in the near term. Another finding was that officers of public institutions are more likely to certify financial statements than officers at independent (private) institutions. Regarding enterprise risk management, the survey found that some universities (49% public and 31% private) have performed risk assessments. Summit participants thought that comprehensive risk assessment would be too expensive for most institutions.

Evidence about how universities have begun to implement SOX is coming to light. Drexel University, the University of Louisville, DePaul University, Eastern Michigan University, Purdue University, and university groups in Iowa and Minnesota have responded to the NACUBO recommendations. Mike Mathis (*Philadelphia Business Journal*, August 8, 2003) claimed that Drexel University is "believed to the first major university to adopt the best practices delineated in Sarbanes-Oxley by amending the school's bylaws in February (2003) to include the act's principles." In a statement on Drexel's website, Constantine Papadakis, the university's president, states:

> As a result, Drexel's corporate bylaws were changed; we established a 'hotline'; and hired internal auditors to determine if we fully addressed the risks our consultants identified. The outcomes: Drexel now has a COSO-based annual audit; our employees have been trained on their new obligations; and we continue to test our key internal controls to help us identify the specific areas that require immediate attention.

EXHIBIT
Percentage of Survey Respondents (Colleges and Universities) Complying with Sections of SOX

		Implementation Rate		
Section	**Description**	**Private**	**Public**	**Total**
201	Public accounting firm independent of organization	100%	77%	85%
202	Preapproval of audit services by audit committee	100%	62%	75%
203	Rotation of audit partner every five years	71%	46%	55%
204	Auditor requirement to submit a management letter or schedule of unadjusted differences	100%	69%	80%
206	Public accounting firm prohibited from hiring CEO, CFO, etc., within one-year preceding audit	29%	54%	45%
301	Is each member of audit committee a member of the board and otherwise independent?	86%	69%	75%
303	Illegal for any officer or director to take fraudulent actions to mislead auditors	71%	77%	75%
401	Application of accepted accounting rules	86%	85%	85%
402	Unlawful for organization to extend personal loans to any director or officer	29%	62%	50%
404	Annual report contains an internal control report	57%	77%	70%
406	Disclosure of adoption of code of ethics	43%	39%	35%
407	Disclosure of whether at least one member of audit committee is a "financial expert"	29%	38%	35%
802	Policy to retain all documents in connection with audit for seven years (minimum)	57%	77%	70%
806	Established whistleblowing policy	71%	54%	60%
1001	Does senior financial manager sign the federal income tax return?	71%	55%	61%
1105	Consider security fraud convictions relevant in background checks for financial employees	43%	54%	50%
Total		65%	61%	63%
Total Number of Respondents		7	13	20

Note: Percentage calculations are based on the number of respondents indicating "Yes" divided by total respondents for the category. For example, public implementation for section 201 is 77% (10/13).

The number of respondents for section 1001 was 18, as there were only 11 public respondents on this question.

In 2006, the University of Louisville established new policies in compliance with SOX principles and recommendations from NACUBO. In its report, "Sarbanes-Oxley Practices," the university used the format suggested by NACUBO. The following are some examples of the new policies implemented:

- Nonaudit services (by external auditor) must be approved by the audit committee (section 201 of SOX).
- The lead audit partner of the external audit team must be rotated at least every seven years (section 203 of SOX).
- The benefits of employing a CFO or controller who worked for the auditing firm within the last year are taken into consideration (section 206 of SOX).
- A compliance oversight council was created to develop a code of conduct (section 303 of SOX).

The website for DePaul University's Office of Institutional Compliance indicates the university's actions to comply with SOX principles and NACUBO recommendations:

> At the request of the audit committee of the board of trustees, DePaul formed the Office of Institutional Compliance to lead such efforts. A university compliance officer was named, and in the spirit of the Sarbanes-Oxley Act, the compliance department created supporting programs such as Management Standards Training, general compliance training, risk assessments, monitoring plans and Quality Assurance Reviews.

In its 2004 Compliance Briefing on the Sarbanes-Oxley Act, Eastern Michigan University (EMU) also used the NACUBO framework. Among the amendments to EMU policy and practice are eight amendments to policy to follow the auditor independence recommendations in sections 201 to 207 of SOX and several amendments to corporate responsibility recommendations in section 300 of SOX.

Purdue University used the format and recommendations from NACUBO to identify its current practices and action items. Most of the action items related to the SOX sections on auditor independence and corporate responsibility. Among those action items were: development of a plan for the audit and insurance committee's review and approval of a confidential compliance mechanism for the receipt, retention, and treatment of reported matters (section 301 of SOX) and the board of trustees' consideration of the adoption of a code of ethics policy and conflict of interests policy (sections 301 and 403 of SOX).

On March 31, 2005, the three Regent universities in Iowa presented a follow-up status report to the audit/compliance committee regarding the efforts of the universities in adopting best practices related to SOX requirements. The universities jointly conducted a gap analysis of the Sarbanes-Oxley provisions and adopted an action plan having three primary areas of focus:

- refinement and development of a business code of conduct;
- development of a confidential reporting mechanism with an antiretaliation provision; and
- refinement of financial certification practices.

John Asmussen, executive director of the office of internal auditing, the Board of Trustees for the Minnesota State Colleges and Universities, suggested in a January 20, 2005, presentation that the board modify its policies about the audit committee and trustee responsibilities. In addition, Asmussen's report identified possible policy implications for the finance/facilities and human resources committees: CEO/CFO certifications on audited financial statements; adoption of a standard framework for internal controls, such as the one created by the Committee on Sponsoring Organizations (COSO); considerations for hiring key financial personnel who were employed by external auditing firms within the past year; extent of background checks when hiring senior officials or finance personnel; and a code of conduct for finance, auditing, and tax personnel (under consideration as an amendment to state law).

The Georgia Institute of Technology (audit.gatech.edu/ei) and Kennesaw State University Foundation have begun to implement sections of SOX. In addition, Paul Hanrahan has written a case study of SOX compliance at Cleveland State University and Case Western Reserve University, "Sarbanes-Oxley for Not for Profit Institutions: Case Study" (2007).

Purpose and Background

The authors surveyed auditors at universities and colleges to determine: 1) the degree to which colleges and universities are implementing the SOX provisions; 2) which specific provisions they have chosen to implement; and 3) their opinions on the usefulness of the rules. Two of the expected outcomes were to obtain a better understanding of current compliance efforts and to learn the auditors' views on how effective implementation has been. Respondents provided demographic information, some financial information, and best-practice policies that were implemented at their respective institutions.

The internal audit director at a private, Midwestern university reviewed the survey instrument and provided additional suggestions for revising it. That school's finance director of administrative affairs also made available the university's voluntary SOX compliance information. The compliance information was a detailed listing of the SOX provisions that have been adopted as best practices by the university, as well as details on the reasons for their adoption. This provided direct insight into

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the type of process that universities go through in developing their SOX best practices. Many of the questions used in the survey are based on this information. Our questions are consistent with the sections of SOX that are identified by NACUBO as relevant for colleges and universities.

Using the research database Reference USA, the authors sent the survey to more than 100 audit directors at universities, colleges, and professional schools and received 20 responses. The following are the demographics regarding the respondents:

- Enrollment: 1,000 to 5,000 students (10%); 5,000 to 10,000 (15%); 10,000 to 15,000 (25%); 15,000 to 20,000 (10%); and more than 20,000 (40%).
- Type of institution: 35% private, 65% public.
- Size of internal audit staff: five or fewer employees (65%); six to 10 (25%); and more than 10 (10%).

Survey Results

Responses to the survey (see the *Exhibit*) confirmed that private and public universities alike are beginning to implement select, cost-beneficial SOX provisions. Overall, the degree of implementation for all sections was 63%, with private universities showing a slightly higher (65% versus 61%) implementation rate. Because of the small sample size, no statistically defensible conclusions about the differences between implementation by private and public universities can be made. The category for which the largest differences in implementation exist is related to external audit services. In those sections of SOX (201, 202, 203, 204, and 206), with the exception of section 206, the private universities show a greater degree of implementation—at least 25 percentage points difference.

The three most frequently implemented SOX sections were sections 201 (85%), 204 (80%), and 401 (85%). Section 201 states that the organization and the public accounting firm should be independent of each other, while 204 deals with the auditor requirement to submit a management letter or schedule of unadjusted differences, and 401 pertains to the application of accepted accounting rules. Adoption of these sections is realistic because these changes apply to any organization and should not be too costly. Three other frequently implemented sections were section 202 (audit committee preapproval of services provided by auditor), section 301 (independent audit committee members and a member of the board), and section 303 (illegal for officers and directors to take fraudulent actions to mislead the auditors), with 75% of respondents claiming compliance for each.

The least implemented sections were section 206 (public accounting firm prohibited from hiring a CEO, CFO, etc., within one year preceding audit), with 45% implementation, and sections 406 and 407, with 35% implementation each. Section 406 of SOX requires all public companies to have a code of conduct for senior management and financial officers that contains appropriate compliance and enforcement procedures, while section 407 of SOX requires public companies to have a financial expert on the audit committee and board or provide an explanation if none of the board meets the criteria. The application of sections 406 and 407 is an area where many colleges and universities may be able to improve.

Colleges and universities should be teaching their students the value of ethics, and they can start by ensuring that their staff has a code of ethics to which they can refer while performing their day-to-day activities. A well-designed code of ethics can be valuable if it is properly implemented within the organization. A properly implemented code of ethics would mean that the code is communicated frequently and enforced, as opposed to being a mere written formality. Another important aspect of SOX for corporations and nonprofits is the willingness for people to step forward with information that may indicate wrongdoing. Information that never reaches decision makers can't be used to achieve a culture of greater trust. Realizing the importance of upward and confidential communication, SOX encourages this type of whistleblowing, directing companies to adopt procedures to protect employees who provide information about corporate financial wrongdoing. Companies are not allowed to "discharge, demote, suspend, threaten, harass, or in any way discriminate" against employees who speak up. The law authorizes criminal penalties for violators. According to the survey, only 60% of the respondents claimed that their university currently has a whistleblowing policy. This is an area that applies to all varieties of businesses and could easily be implemented by more universities.

Only one of the 20 respondents claimed that there were sections that they felt would be beneficial that have not been adopted or were not in the process of being adopted. The reasoning was that management outside their area wasn't convinced of the benefit. In addition, 25% of respondents claimed that their organizations have experienced an increase in the number of staff members directly related to SOX, with the average increase cited being 20% of their budget. But relative to the size of those universities' internal audit staffs, this increase would only translate to an average increase of one staff member.

One result of the survey was that there is not a significant difference between private and public universities' compliance efforts. As a whole, private institutions had a slightly higher level of compliance of total sections polled. In certain sections, such as 206 and 402, the public institutions had higher levels of compliance, while in other sections, such as 201, 202, and 204, the private universities had higher levels. Overall, the differences were minimal, reflecting the nonexisting requirements for implementation among public universities. One possible explanation for private institutions having a slightly higher compliance rate is that they may be able to more easily obtain board approval for the required additional expenditures, while public institutions may have more trouble because they have to ultimately answer to their corresponding state governments. The differences are still negligible and most likely will remain that way unless states begin implementing mandatory compliance with certain SOX provisions (in which case public universities would most likely have a higher compliance rate than private).

A few institutions noted increases in the size of their internal audit function, but the important thing to consider is whether the benefits exceeded the costs. The survey asked respondents to indicate whether the benefits of compliance have outweighed the costs on a scale from 1 (strongly agree) to 5 (strongly agree). The average response, 2.75, fell between slightly agree and indifferent. This indicates that universities are seeing the benefits of SOX. Most likely, this will lead to additional compliance in the near future. Furthermore, the survey also requested directors to rate how SOX has affected their relationship with external auditors from 1 (no effect) to 5 (more than significant effect). The majority believed that their institution has not been overly affected by the SOX compliance. The average score among respondents was 1.75, which indicates the majority did not notice a major difference in their relationships with their external auditors.

Benefits and Opposition

There is evidence that many educational institutions are already voluntarily complying with SOX principles and NACUBO recommendations because they believe it will benefit them. Smith provides some evidence of attitudes of business officers toward implementation of SOX at universities and colleges, and NACUBO's survey documents the degree of implementation up to 2004. Other universities and colleges are discussing the possibility. Out of the 20 respondents to the authors' 2008 survey, only one university, a public institution, reported zero compliance with SOX principles. These compliance efforts demonstrate that the SOX provisions have advantages beyond the comforting effects that they provide to shareholders and other stakeholders. Many provisions, such as a whistleblowing policy, a code of ethics, and auditor independence, are critical to all organizations, not just publicly held businesses. Additionally, the benefits are often worth the costs. The outlook for mandating SOX-like legislation for nonprofits is unclear, both at the federal and state level. There is evidence, however, of some opposition to the implementation of SOX principles at universities. One example is from Roger Bowen, who writes in *Academe Online* ("From the General Secretary: Sarbanes-Oxley," May/June 2006, www.aaup.org):

> In brief, Sarbanes-Oxley indoctrinated trustees will be tempted to micromanage executive functions and nullify or lessen the right of faculty to share in governing the university.
>
> If Sarbanes-Oxley insinuates itself into the academy, either by force of law or by "indoctrinated" trustees, it will only advance what the Council of Independent Colleges has called "federalization." What we need instead is "localization," a process whereby faculty budget committees, working within a framework of shared governance, serve as the preferred mechanism for guaranteeing administrative transparency and accountability for institutional financial operations. I suspect that most presidents and financial vice presidents would prefer to deal with a faculty budget committee rather than corporate leaders acting in the capacity of trustees. ❑

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