Search The Site
Go
More options | Back issues

Home
News
Opinion & Forums
The Chronicle Review
Forums
Colloquy
Careers
Sponsored information & solutions
Chronicle/Gartner Leadership Forum
Services
Help
Contact us
Subscribe
Manage your account
Advertise with us
Rights & permissions

THE CHRONICLE OF HIGHER EDUCATION
The Chronicle Review

From the issue dated July 8, 2005

Sarbanes-Oxley and College Accountability

By ALEXANDER E. DREIER

In the summer of 2002, following scandals at the Enron Corporation and other public companies, Congress enacted sweeping securities-law reform in the form of the Sarbanes-Oxley Act. The law mandates -- or, by requiring disclosure, strongly encourages -- the adoption of a host of financial-reporting and governance measures. Except for a few relatively discrete provisions, Sarbanes-Oxley -- used here as shorthand for both the law itself as well as various federal regulations and stock-exchange rules that emanate from it -- applies only to public companies.

Nonetheless, the splash the law has made has left the boards of some colleges, universities, and other nonprofit organizations bobbing on a sea of uncertainty. As the act's requirements have taken hold, trustees and lawmakers have been grappling with whether to apply Sarbanes-Oxley to higher-education institutions and, if so, how its requirements, which Congress crafted for public companies, should affect nonprofit colleges and universities.

The Senate Finance Committee recently held hearings on nonprofit accountability that have focused interest on the issue. A series of well-publicized scandals at non-profit organizations -- although notably few involving colleges or universities -- no doubt has contributed to legislators' sense that more regulation is needed. To help curb perceived excesses in some nonprofit executives' compensation and benefits, the Internal Revenue Service has already moved to beef up disclosure on the 990 forms that nonprofit organizations file. In addition, several states are considering legislation that would apply, to a greater or lesser extent, Sarbanes-Oxley-like provisions to nonprofit organizations.

Thus far the question of whether Sarbanes-Oxley benefits a college or university has been left to each board to answer. College trustees who are also public-company officers or directors have brought their corporate experience with Sarbanes-Oxley to their institutions' board rooms and have asked, If Sarbanes-Oxley is important in the corporate setting, why shouldn't we adopt it here? Some board members have been concerned that, as other colleges adopt Sarbanes-Oxley reforms, failure to follow suit could expose their institutions to liability if they are perceived as outliers. In other cases, trustees have heeded advice from outside consultants or lawyers that wholesale adoption of Sarbanes-Oxley is now a "best practice." Some donors, providers of directors' and officers' liability insurance, and bond-rating agencies say they are taking Sarbanes-Oxley practices into account.

But anecdotal evidence suggests that while many institutions have introduced elements of Sarbanes-Oxley into their governance and financial-reporting structures, few have embraced it fully. According to a recent informal online survey of 179 chief financial officers at private and public colleges conducted by the Association of Governing Boards of Universities and Colleges, although most boards had discussed Sarbanes-Oxley, fewer than one-third were "very familiar" with its terms, while 59 percent were only "somewhat familiar."

Specifically, Sarbanes-Oxley tightens regulation of outside auditors, while at the same time seeking to bolster their independence from company management by, for example, restricting the nonaudit services they may perform. It requires boards to have a separate audit committee that receives the outside auditor's reports and includes a financial expert. It also aims to increase board independence by, for example, barring management insiders from certain board committees.

In addition, company CEO's and CFO's are required to certify that financial reports are accurate and to assess annually the company's system of internal controls. Codes of ethics for employees and directors must be adopted, and whistle-blowers must be protected from retaliation.

To date, colleges and universities have adopted such measures with varying degrees of enthusiasm. About 60 percent of the institutions that replied to the governing-board association's survey had a separate audit committee and a code of conduct, yet most of those were in place before Sarbanes-Oxley. The law has prompted relatively few of the organizations to formally designate a member of the audit committee as a financial expert, although many of the audit committees in fact include financial experts. The majority of the institutions responding to the survey do not have the chief executive certify the accuracy of financial statements, although most have the chief financial officer do so. Most of their boards have not adopted the practice of formal assessment of internal controls by the CFO, and such certifications by the CEO are rare.

In fact, some trustees see a danger that preoccupation with Sarbanes-Oxley may distract the board from other equally or more pressing business. Moreover, while many of the legislative and regulatory measures have lumped together higher-education institutions with other nonprofit organizations, a strong case can be made that colleges should not be subject to the same rules as, for example, family foundations. Colleges and universities are complex organizations, generally comprising a multitude of separate programs and departments. Because each of those entities may have its own measure and definition of success, it would be burdensome, and probably not very meaningful, for institutions to supply the government with annual reports gauging whether they have achieved their success in achieving organizational goals, as one proposal by Congressional staff members would require.

As Derek C. Bok, a former president of Harvard University, told the Senate Finance Committee in 2004, "it is not at all clear that the benefits derived" from detailed disclosures to the government "will justify the substantial expenditure of time and effort required to prepare them." In addition, the culture of many universities, which encourages highly decentralized decision making in the academic sphere, may be difficult to align fully with the Sarbanes-Oxley culture, which emphasizes top-down accountability.

Higher-education institutions as a group also differ from most charities in that they are already highly regulated. Almost all colleges and universities receive federal money -- most of it in the form of student financial aid and research grants -- for which they must account under highly developed government rules. As evidenced by articles in the pages of *The Chronicle,* the government vigorously enforces those rules when charges of waste, fraud, and abuse arise in federally financed programs at universities. Audited financial statements are required, and there are stiff penalties for noncompliance. Whistle-blowers are protected under various federal statutes and rulesfor example, the False Claims Act, which authorizes lawsuits against employers that retaliate against employees who report fraud.

Colleges and other nonprofit organizations also are already subject to IRS rules designed to ensure that insiders do not enrich themselves at the expense of the organization.

As some trustees have observed, the wholesale adoption of Sarbanes-Oxley might not provide for an institution the positive benefits that more reflective, deliberative consideration of the individual elements of that law would provide. Measures that some universities have already adopted in response to Sarbanes-Oxley may not be appropriate for all institutions. For example, some institutions have thus far determined not to adopt a Sarbanes-Oxley-style overarching code of conduct, believing that specific policies governing conduct in particular situations -- for example, workplace relations or grants management -- work better for their institution.

That is not to say, however, that universities should not work to improve governance and financial management. Many American universities developed their basic management structures half a century ago or more; 21st-century universities (and some colleges) often operate more like business corporations than they did in those earlier days. They raise and invest vast sums of money, engage in complex commercial transactions, offer their services to industry, do business all over the world, and employ large work forces. As the reach, scope, and missions of these institutions change, it is only logical that they should adopt more formalized, efficient, and transparent management techniques. And in the post-Enron environment, failure to detect malfeasance is likely to be punished more severely, whether the punishment takes the form of harm to reputation or legal sanctions. The stakes are higher now.

Whether or not a board should adopt any particular Sarbanes-Oxley reform may be highly dependent on local factors. However, some of the measures may benefit many college boards. For a board that does not have one, for example, would establishing a separate audit committee bolster confidence in the independence of the external audit? Including a trustee with sufficient financial experience on the audit committee may be deemed a good practice because it advances the board's ability to handle technical aspects of the audit. Boards may also wish to consider whether membership in certain committees -- for example, those charged with nomination of trustees and executive compensation, as well as audit -- should be limited to "independent" trustees who have no financial relationships with the institution. Those examples are merely illustrative. Sarbanes-Oxley invites college boards to thoughtfully consider whether adoption of its various provisions is the right thing for their institution.

Apart from specific provisions of law, the spirit of Sarbanes-Oxley suggests that boards evaluate a range of policies and practices from the perspective of general principles of good governance. One area in which many colleges could do a better job, for example, is in creating and enforcing clear policies on trustee conflicts of interest. The specifics of such policies may vary according to state law. But most will include clear procedures for disclosure and review of financial interests, guidelines on the type and magnitude of reportable interests, and well-defined procedures for board consideration of matters in which a trustee has a conflict of interest (for example, should the interested trustee be absent from the room or merely abstain from voting?), as well as dealing with a range of other issues like the significance of a trustee's family members' financial interests. Such policies, many of which cover both officers and trustees, can help to avoid the reality and the appearance that trustees or college officials are inappropriately benefiting from their position.

To cite another example, some boards are excessively dominated by the executive committee or a small group of active trustees. But dealing with such problems presents special challenges for universities, and the answer may not be a simple legislative mandate, like a cap on the size of nonprofit boards. Because colleges and universities, unlike for-profit organizations, have always depended on the kindness of trustees to donate time, treasure, and talent, forcing an institution to choose between an active trustee and a passive yet generous one could harm the institution. If they wish, boards can avail themselves of tools to deal with that problem, like trustee self-evaluation, rules on board-meeting attendance, trustee term limits, or emeritus or honorary status for some trustees. Government legislation mandating a maximum size for all nonprofit boards is not the best solution to this complex problem.

For their part, legislators should recognize that medicine derived from corporate experience will not always be an appropriate cure for what ails a university's board. While it goes without saying that higher-education institutions should be held accountable for financial management, particularly when it comes to handling government funds, policy makers should carefully consider the effects before they make regulations drafted for business corporations apply to colleges and universities.

Few organizations, for-profit or nonprofit, could claim there is no room for governance improvement. Yet one notable fact about American higher education is the relative rarity of large-scale fraud and abuse. Universities should not be complacent about good governance, but it is far from clear that there is anything resembling a crisis in financial accountability among the nation's colleges and universities that would warrant adoption of rules designed in a different context.

Alexander E. Dreier is a partner in the higher-education practice in the Washington office of Hogan & Hartson.

http://chronicle.com
Section: The Chronicle Review
Volume 51, Issue 44, Page B10