



Does Sarbanes-Oxley Financial Oversight Provisions Apply to Not-For-Profit Organizations? By Laurence Scot, MBA, CPA

Time and again the question is raised, are Not-For-Profit (NFP) organizations required to comply with the provisions in “*The American Competitive and Corporate Accountability Act of 2002*” (generally known as **Sarbanes- Oxley Act** or **SOX** for short). In a nutshell the answer is basically NO. With two exceptions, SOX only applies to publically traded, for-profit organizations. The two exceptions are: making it a crime to take action against someone who reports improper financial management or employment practices by an organization (whistleblower protection), and the rule making it a crime to intentionally destroy documents to impede a government proceeding or investigation. That being said, should NFPs be concerned with adhering to SOX? The answer is YES but only if it cost effective and actually improves oversight of the organization financial activities.

“Good Governance” Provisions

Two of SOX’s provisions most discussed and debated by NFP Boards are, the establishment of an independent and competent board audit committee and audit firm rotation. The remainder of this article will discuss the pro and cons of complying with these two provisions.

Establishment of an Independent and Competent Board Audit Committee:

SOX requires that an organization establish a separate, independent audit committee with one or more financially literate individuals. The rationale for this is, a separate audit committee will provide a needed level of oversight of a company’s financial reporting processes, their internal controls and the work performed by their independent auditors.

Pros – Even though a separate audit committee is not required for NFPs, it is believed by some that having a separate audit committee, with one or more financially knowledgeable members, will ensure that the audit process (from auditor firm selection to the reviewing of the auditors’ report) will receive the appropriate amount of attention and oversight that it deserves. In addition to overseeing the audit process, the committee’s duties would typically include

internal financial oversight to ensure that management develops and complies with appropriate and useful internal controls.

Cons – It is no secret that large and prominent NFPs have robust and sizable Boards but small to medium size NFPs have smaller Boards plus a difficult time finding and retaining active and competent Board members. When an organization has 12-20 Board members it becomes practical, and many times necessary, to breakup Board duties and responsibilities by having various committees perform different tasks. Most of these organizations recognize the importance of financial oversight and will typically have a budget and/or finance committee. If the Board is large enough, for the reasons previously mentioned, they might also have an audit committee. However, when an organization has only a small number of Board members, with maybe only one or two financially literate members, it becomes ludicrous to have a separate audit committee made up of the same individuals that also sit on other committees . This becomes an issue of form over substance.

Audit Firm Rotation:

The corporate scandals in the 1990s and the related complicity and professional negligence by the CPA firms auditing those scandalous corporations, mandated that improvements were needed to ensure audit independence and the integrity of financial reporting. It was decided that one way to enhance audit independence was to institute mandatory auditor firm rotation every five years. The underlying theory was, long-term relationships between an organization and their independent auditors creates a “closeness” that impinges the auditor objectivity and the professional skepticism that they need to properly perform their function.

Pros – Many NFP Board members either believe incorrectly that audit rotation rules are applicable to NFPs or feel that it is prudent and shows good governance and fiduciary responsibility by rotating audit firms every three to five years. Some believe by switching firms there will be a “new set of eyes” examining their organization’s financial records and better audits will be performed resulting in the detection of errors, misstatements or improper or illegal acts. Others believe that audit fees will be lowered due to new competitive bidding.

The truth is, sometimes auditors are incompetent or do in-fact become complacent. Indications of incompetency or complacency may include, but are not limited to, a combination of several of the following: a lack of knowledge of NFP accounting and reporting rules, having an open-ended engagement letter, never suggesting year-end adjusting journal entries and never finding deficiencies or issuing a “management letter” with suggestions for improving internal controls. If these or other issues exist, switching to a new audit firm will greatly improve oversight and financial reporting reliability and provide an Organization’s Board and external stakeholders with an increased level of comfort.

Cons - There are many reasons against audit firm rotation (other than it is not applicable to NFPs), which was summed up best in the December 11, 2011 response by the American Institute of CPAs (AICPA) to the Public Company Accounting Oversight Board’s (PCAOB) request for comments about audit firm rotation (the PCAOB is an entity created to enforce SOX provisions).

“We believe that mandatory firm rotation carries significant costs and possible unintended consequences that have the potential to hinder audit quality rather than the intended goal of enhancing audit quality. In fact, numerous academic studies indicate that audit quality actually increases with audit firm tenure. Experience and knowledge of the organization’s operations and industry are crucial to a high quality audit and such knowledge and experience increases with audit tenure.”

The IRS also considered the issue of audit firm rotation when redrafting the 990 form and came to the conclusion that the costs and potential problems outweigh the potential benefits of rotation.

Typically NFP organizations, especially smaller ones who have limited resources and in-house financial expertise, rely heavily on their external auditors for accounting and technical guidance. What’s more, many NFPs have significant staff and Board turnover leaving their external auditors as the only ones with organization knowledge or “institutional memory”. So rotating the auditing firm could possible remove one of the few consistencies

an organization has and deprive the organization of a valuable non-auditing resource.

Then there is the issue of cost. Contrary to the belief that money can be saved by rotating audit firms, audit rotation actually increases costs. A significant amount of time will be spent by the Board, management and staff preparing and sending out RFPs and interviewing and hiring a new auditing firm. Then a significant amount of additional time will be spent educating the new firm on the organization’s operations. All this additional time becomes a hidden cost that is rarely considered by the proponents of audit firm rotations.

Another negative aspect of rotating audit firms, described by the AICPA in their response letter to the PCAOB, is that “mandatory firm rotation may also result in a greater risk of fraud and therefore, adversely impact audit quality. Specifically, academic research indicates that fraudulent financial reporting is more likely to occur in the first three years of the auditor-client relationship”.

One last point needs to be mentioned. Section 203 of the 2002 SOX Act does not require audit firm rotation but rather states that the audit partner (having primary responsibility for the audit) or the audit partner responsible for reviewing the audit has to be rotated every five years. So an organization can request that their audit firm rotate the audit partner in-charge of their audit and be in compliance with SOX without losing the accumulated experience their current audit firm has gained over the years.

Conclusion

Excluding the two exceptions noted , SOX does not apply to NFP organizations. NFPs should not create a separate auditing committee unless their organization and Board size justify its creation. NFPs should also not periodically rotate their auditing firm (based on some misunderstood concept of prudence or good governance) unless they believe their existing auditors are inexperienced, lack industry knowledge, are incompetent or are being complacent. Because doing so could have detrimental consequences. Great care and serious consideration should be given before making any decisions.