Myths and Truths about Not-for-Profits

Part I

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You've heard them before:

- "Not-for-profits must follow Sarbanes-Oxley."
- "None of Sarbanes-Oxley applies to not-for-profits."
- "Not-for-profits must change auditors every five years."
- "Not-for-profits should not have too much profit or they will lose their exempt status."
- "If you have lots of reserves, you will be targeted for an IRS audit."
- "If you file an extension for your Form 990, you are more likely to be audited."

What is truth and what is myth? Let's tackle them one at a time.

1. **Sarbanes-Oxley** – The Sarbanes-Oxley Act was passed in 2002 and was a sweeping reform bill that targeted public companies, management and public accounting firms. It was a direct response to the various accounting scandals that were hitting the news at that time, particularly Enron, WorldCom and other public companies. The government mandated several reforms and new requirements that were aimed at preventing another corporate collapse due to malfeasance. Except for two provisions, it was not aimed at privately-held companies or at not-for-profit organizations. It primarily applies to public companies and their auditors.

   The two provisions of the Act that have universal application are those that are part of the "Corporate and Criminal Fraud Accountability" and "Corporate Fraud and Accountability" portions of the Act. Section 802 deals with knowingly altering, destroying, mutilating, concealing, etc. records. It is affectionately referred to as the "no shredding" provision. If any corporation, including a not-for-profit corporation, is found to be impeding or covering up an investigation by the U.S. Government, there are penalties and prosecution, even jail time, in store. So not-for-profits are responding by ensuring that they have a good record retention policy in place that specifically addresses that any record destruction is stopped when a governmental investigation has been initiated.

   Section 1107 includes criminal penalties if anyone retaliates against a whistleblower. So the not-for-profit response has been to ensure that they have policies providing for whistleblower protection as well as mechanisms to ensure that whistleblowers get heard and know who to contact when they have concerns.

Sarbanes-Oxley (Continued)
Many not-for-profits have set up whistleblower hotlines where people can call to report, and their anonymity is maintained.

Although those are the only two items that are specifically applicable to not-for-profits, many of the other things mandated by Sarbanes-Oxley have “trickled down” to not-for-profits, primarily through new reporting requirements in the revised Form 990, and because many not-for-profit Board members operate in the public company arena and are used to those practices. However, the fact is that Sarbanes-Oxley is not applicable, as a whole, to not-for-profit organizations.

2. **Auditor Rotation** – The topic of auditor rotation for publicly traded companies is addressed in Section 203 of the Sarbanes-Oxley Act, which requires that public companies rotate the **partner** on their audit every five years. There is no requirement for the audit **firm** to change, only the partner. Of course, its provisions are not applicable to not-for-profits, but one often hears comments such as, “We’re required to change auditors every five years.” Not true.

   In fact, the U.S. General Accountability Office (GAO) published a report in November 2003 on its study of the potential effects of mandatory audit firm rotation. The question they were trying to answer was whether the independence of the auditor was adversely affected by a firm’s long-term relationship with the client. The study found that “mandatory audit firm rotation may not be the most efficient way to strengthen auditor independence and improve audit quality considering the additional financial costs and the loss of institutional knowledge…” A survey done as part of the research found that mandatory audit firm rotation would lead to more costly audits because of the costs involved by the auditor in acquiring the necessary knowledge of the new auditee and the costs incurred by the auditee in selecting and supporting the new auditor. In addition, there are marketing costs incurred by the auditors as they participate in the proposal process that are passed along to the auditee.

   The American Institute of Certified Public Accountants (AICPA) also published a document in 2003 titled “A Reasoned Approach to Reform”, which found that requiring audit partner rotation for audits of private companies would likely increase the audit fees charged. Many firms would not be able to participate because they only have one partner, and thus a partner rotation requirement would mean that the firm would be disqualified from serving the client after their five-year term was up.

   This study also found that there is no evidence that audit partner rotation guarantees better audits. In fact, research finds that “audit failures are three times more likely in the first two years of a client/auditor relationship, and that there is a positive relationship between audit firm tenure and auditor competence.” They also note that the longer an auditor works with a company, the more often material financial statement errors are discovered.

   The conclusion was “Knowledge of the client, its business and the environment it operates in is essential to audit quality. Without these, audit quality would decrease. It is clearly in the public’s interest to keep the most qualified partner on the job.”

3. **Earning a “Profit”** – Is it OK? Aren’t we a not-for-profit? Doesn’t that mean we shouldn’t have a profit? This myth is complicated because there is a grain of truth to it. Without a “profit” or “surplus”, the organization would be out of existence within a short period of time. That positive bottom line is what enables you to buy those fixed assets that you use in your mission. It allows you to build those reserves that will support your operations regardless of current donations. It allows you to expand and grow. Organizations **must** have a “profit” to stay healthy.

Earning a "Profit" (Continued)
How does the IRS regard an organization with a healthy, positive bottom line year after year?

"Non-profit" is a state law term of art, which means the profits of the organization do not inure to the benefit of any individual. A prohibition on private inurement is one of the requirements for attaining federal tax exempt status.

There are two basic types of public charities. The first obtains most of its revenue from contributions. If year after year the organization has more contributions than expenses, it is possible the IRS would inquire as to what the build-up of reserves is for. However, it is more likely that donors will ask this question first with the logical result being a drop off in contributions from the public.

The second type of public charity receives support from a combination of contributions and revenues earned from exempt activities. The IRS is more likely to take a close look at this type of organization. The risk is the IRS will find that the organization is operating in a commercial manner with an unfair competitive advantage of no federal income tax burden that other similar for-profit providers operate under. The result of IRS scrutiny may be that the organization is subject to unrelated business income tax on the activities. If in fact the activity generating the surplus is a trade or business conducted in a commercial manner, or on an ongoing basis that competes with other taxpaying organizations, there is a risk of taxation and/or revocation of exemption. The argument that the activity is related to the organization's exempt purpose can be persuasive in excluding it from taxable income. However, if a tax paying entity is conducting the exact same activity and paying taxes on the net profits, the IRS is likely to take issue with the organization's exemption with regard to this activity and possibly its exempt status in general.

Currently, Congress is taking a very close look at many tax exempt sectors, including schools and hospitals, to determine what differentiates the taxable from the non-taxable organizations. Organizations should be aware of surpluses generated and mindful of what is creating the surplus as well as have an explanation of what the planned use is for any accumulated reserves.

4. **Reserves and IRS Audits** – Does the IRS target organizations with accumulated operating reserves for audit?

   The short answer is the IRS does not reveal what triggers the audit of any taxpayer or tax exempt organization. Anecdotal evidence suggests the following as being the most common reasons for examination:
   - Referral by a current or former employee.
   - Referral by a for-profit organization complaining that the non-profit is competing with an unfair competitive advantage as a tax exempt organization.
   - Mismatching of third-party reporting documents. For example, a K-1 filed by a partnership not reported by the member taxpayer on its annual tax return.
   - Internal inconsistency or mathematical errors in the return filed with the IRS.
   - Missing schedules or disclosures.
   - Failure to timely extend or file a tax return.

5. **Extensions and IRS Audits** – There is no evidence that organizations filing extensions are more likely to be audited. In fact, the opposite may be true. The bulk of returns pulled for examination are taken from the first filing deadline.

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We would be happy to assist you with any of your questions. Please call us at 941-365-4617 or email Rob Lane at rlane@kbgrp.com or Patricia Entsminger at pentsminger@kbgrp.com.