To RFP, or not to RFP: that is the question

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I attended the recent Delaware Association of Nonprofit Agencies (DANA) Annual Meeting and Conference – it was great to see the renewed energy at DANA and the enthusiasm of the Board and the attendees. The guest speaker (Vicki Clark – a renowned author and consultant from BoardSource) had many good points in her presentation. She did make a comment near the end, however, that caused me some concern – that nonprofits should "re-evaluate their relationships with auditors" (among others) "every three years."

I am often asked about my views on requiring auditor rotation as a matter of policy. My semi-facetious, one-line response is that it depends if the person asking is a current client of mine or not. If re-evaluating means a complete request for proposal (RFP) process every three years – regardless of your satisfaction with your current relationship – then I'd like to offer a different perspective.

Auditor Rotation in the News

Auditor rotation has become a major bone of contention between Congress and the Securities and Exchange Commission (SEC). The "pro mandatory rotation" thought process is that a new audit firm will provide a "fresh look" at the entity's finances and systems and will be more likely to provide a truly independent perspective than a firm that has been involved for many years. It is possible to read these stories and attempt to draw the comparison between publicly traded corporations and nonprofits, but that comparison is imperfect. There are fundamental differences in the auditor / client relationship between most SEC filers and nonprofits that make mandatory rotation somewhat more desirable for large companies. A 2003 study found that the average tenure of auditors at Fortune 1000 companies was 22 years. Ten percent had been with the same audit firm for 50 years or more! These stats are all the more remarkable given that roughly 20% had been forced to rotate the previous year with the demise of the giant CPA firm Arthur Andersen (Enron's auditor). At SEC filers – particularly those with long stints with the same audit firms – many senior members of the accounting staffs are alumni of the audit firm. In those cases, there is an obvious potential for pressure if, for example, the senior executive at the client and the partner at the audit firm came up through the ranks together. Also, the auditors might view the audit as an extended job interview and be hesitant to take a hard line on issues.

Costs vs. Benefits of Mandatory Rotation

A provision of the Sarbanes-Oxley Act of 2002 (the response to Enron and WorldCom meltdowns) required the Government Accountability Office (GAO) to conduct a study of the potential impact of requiring mandatory rotation of audit firms. The GAO released its 98-page study the following year. To be fair, the study relies heavily on the responses of public accounting firms and their clients (among others) in formulating its findings. With that in mind, the study predicted that audit fees would rise by 20% as firms struggled to deal with the increased up-front cost of assimilating new clients more frequently. The study also predicted that the potential for "audit failure" (the failure of the audit to identify material misstatements of the audited financial statements) would increase as the familiarity with the client decreased due to mandatory audit rotation. The study concluded that it would be more efficient and effective to ensure that the audit committee of the corporation had sufficient resources to carry out its increased oversight responsibilities under Sarbanes-Oxley.

2002 presented a golden opportunity to study the "fresh look" impact of mandatory audit firm rotation. As discussed earlier, with Arthur Andersen's sudden departure, approximately 200 of the Fortune 1000 were required to find new audit firms. A study was conducted which measured the number of restatements of previously issued financial statements of those 200 vs. the rest of the population. A restatement would indicate that the previously issued financial statements were wrong, but would not necessarily identify the cause or how that was uncovered. The result was that re-statements were more common in the 200 – by a margin of 2.7% (1.2% for the general population vs. 3.9% in the 200). Yes, a difference, but not a large one, and the root causes were not clearly identified.

<u>The Business Side</u>
It absolutely makes sense to shop commodity-type services. With copier leases, office supplies, computers, etc., there can be very little differentiation in the product so price becomes the focus of the decision. The same is not true for lawyers, doctors, investment advisors and other service providers – when you find a good one you stick with them.

We have always advocated our belief that an audit is not a commodity and that all audits are not alike. Yes, you get those pretty bound financial statements, but your auditors should also be helping to guide your organization through changes, acting as a resource to your accounting staff for questions that arise during the year and discussing upcoming changes in the accounting and tax environment that may affect your organization. In my experience, the value added from those services will increase over time as the auditor becomes more familiar with your organization and systems and as your staff is more comfortable coming to them with questions.

There is an inherent conflict of interest in every audit – auditors are paid by the people we are auditing and at the end of the day, public accounting is a business. This conflict exists whether the auditor has been engaged for one year or fifty. It takes a serious effort to maintain objectivity in any audit, whether the relationship is new or longstanding. We have been "fired" as auditors several times for sticking to our guns on issues, and in the short-term that is a painful experience.

If, according to Ms. Clark, "re-evaluating the relationship" means questioning the auditors and challenging them on procedures performed, the reasonableness of their fee, the findings (or lack thereof) and the value added by their services, then I would say that should be done every year, not every three. If you are dissatisfied with the services provided by your auditor, there is no valid reason to wait three years to make a switch. But mandatory rotation (changing for the sake of change) will not ensure the development of the most efficient and effective audit relationship for your organization.

If your organization has questions regarding auditor rotation, please contact Pete Kennedy, or any other member of our Nonprofit Practice team, at Cover & Rossiter at (302) 656-663

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