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Clubs' Adoption of the Sarbanes-Oxley Act

Introduction

As a result of the many accounting scandals involving companies such as Enron, Tyco, and WorldCom, the Sarbanes-Oxley Act (SOX) (U.S. House of Representatives 2002) was passed. This Act is intended to protect investors in public companies from financial abuses. SOX requires public companies to develop stringent internal controls as well as improved oversight to their operations. The hope was that those companies would become more transparent, more truthful and have better accountability when reporting transactions.

SOX contains eleven titles or sections that cover areas ranging from increased corporate board responsibilities to criminal penalties. Specifically, some sections cover assessing internal controls, audit committees, external auditors, and the board of directors.

Provisions of SOX do not apply specifically to nonprofit organizations or even to privately held companies, which are the categories that most private clubs are in. Still several provisions of SOX are applicable to nonprofit organizations such as social clubs.

SOX requires companies to have audit committees that include independent members who are also on the board of directors. Further, SOX requires that companies report whether at least one member of the audit committee has a financial background and that the audit committee is responsible for communicating with the external auditors. This provision is to ensure that published financial statements are understood.

SOX focuses as well on a firm's system of internal controls. SOX requires the annual report contain a section called "internal control report." Management is required to periodically document and test the internal controls in place within the firm. This provision is designed to reduce the internal control breakdowns resulting in business failures.

To what extent have clubs voluntarily complied with provisions of the SOX Act for which they are not required to comply? Little research has been done on the extent to which various nonprofit organizations have adopted the provisions of SOX, and the studies that have been completed were not comprehensive in scope. For example, Grant Thornton (2006) attempted to assess in general, the extent of governance of nonprofit entities by conducting a nationwide study. However, that study focused strictly on large companies with annual budgets over $20 million.

Vermeer, Raghunandan, and Forgione (2006) also conducted a study of nonprofit entities, but that research focused narrowly on the composition of the audit committee of nonprofit organizations and the various factors that were related to their composition. In that same year Broude (2006) surveyed a small group of 20 nonprofit organizations and found that these organizations were voluntarily adopting certain measures of SOX as a set of best practices. Smoker and Mammano (2009) offered an explanation why many nonprofits had voluntarily adopted certain measures of SOX, and concluded that the best practices set forth in SOX constituted baseline behaviors for good corporate governance for these organizations.

However, some six years after the passage of SOX, Mead (2008) found that many states were considering passing laws for corporate reform of nonprofits and that states such as California, Connecticut, New Hampshire, and West Virginia had already passed such laws. Why were states pushing for the reform of nonprofits? Yallapragada, Roe, and Toma (2010) found the increased pressure for some state legislatures as well as the federal government to extend SOX-like provisions to nonprofit entities was the result of the recent malfeasance and outright fraud in many high visibility nonprofits such as United Way and the American Red Cross.

Iyer and Watkins (2008) believed that they had conducted the first comprehensive academic study of nonprofit organizations' efforts to implement SOX provisions voluntarily. They reported that many nonprofit entities already had governance measures in place that were similar to SOX. Their analysis included a regression analysis on a composite SOX measure. An important finding of that analysis was that the presence of an external and/or internal auditor in a nonprofit entity is significantly related to the adoption of certain SOX measures.

Nezhina and Brudney (2010) used Poisson regression models to attempt to explain the variation in the level of adoption of SOX by nonprofit organizations. They found that the level of SOX adoption by nonprofits was determined to a large extent by the nonprofit organizations' accountability and transparency structure prior to the enactment of SOX. When they took that factor into account, they concluded that the level of adoption of SOX by nonprofits was modest.

Adoption of the provisions of SOX could be very advantageous to clubs. A club audit committee, for example, with independent members could provide a valuable periodic review of club operations to management. Also, having at least one member of the audit committee with a financial background could provide better communication between the club and the external auditing firm. Further, installation of a system of internal control, mandating an annual test of those controls by management could reduce the chance of losses and potential club failure. Also having an external audit of a club's financial statements provides greater assurance that the club's financial statements can be relied upon by outsider users such as financial institutions. Finally, having a relatively large Board of Directors with independent members should provide improved oversight of a club's financial statement presentation.

Research Methodology

In order to study these issues in more detail, a survey instrument was developed that involved two parts; the first covered general demographic data including the position of the respondent, size of club in terms of members and gross revenue. The second part of the survey dealt with issues that related to specific sections of the SOX Act, how familiar respondents were with the SOX Act.

Questions included on the questionnaire covered major areas as follows:

1. Audit committees
2. Board of directors
3. Internal controls of the club
4. External auditors

Respondents were also asked what their familiarity with SOX was and whether they believed that SOX should be mandated for all clubs.

The questionnaire was mailed to 1000 club financial executives randomly selected from the membership list of Hospitality Financial & Technology Professionals (HFTP).   Only HFTP members whose address included a club name were considered as part of the population of club financial executives. Fifty surveys were returned as undeliverable. One hundred and seventy-nine responses from the remaining 950 in our sample were returned and used in this research. The response rate was 18.8%.

Statistical analysis was then performed on the data in order to determine whether there were significant differences in the various responses to certain measures included in SOX based on selected demographics of the responding financial executives of their clubs. **General**

Demographic Findings

The demographic data collected in the survey are summarized in Table 1. As shown in this table, the majority of the respondents to the survey were controllers (62%) while the rest held various positions such as CFO, assistant controller etc. It appears that the respondents were in positions to be reasonably knowledgeable of their clubs "compliance" with SOX. Most of the clubs in the study were best described as country clubs (69%) with the rest being called city clubs, yacht clubs or various other types of clubs. The annual gross revenues of the clubs ranged from less than one million (2%) to over $10 million (30%).

The most common size of club in terms of number of members was between 250-500 members (28%), followed by the category of 501-750 members (24%), and just over 10% of the clubs had over 2,000 members. As expected, the vast majority of the clubs (91%) were not-for-profit entities.

The median club made a bottom-line 2009 profit of $23,044. As shown in Table 1 over a quarter of the clubs experienced a net loss for 2009 of over $100,000, while nearly 25% of the responding clubs earned profits of over $300,000 during 2009.

Sox- Related Findings- Audit Committee

The findings related to the audit committee are found in Table 2. They reveal that just over 58% of the respondents indicated that they were somewhat familiar with the SOX Act, about 15 % were very familiar with it, while the other 27% were either not very familiar or not familiar at all with the Act. These results are not surprising since the SOX Act was written primarily for public companies and most clubs are private not-for-profit organizations. Still since a number of states have passed financial reform laws covering nonprofit organizations and others may in the future, it appears club financial executives should increase their knowledge of SOX and similar laws.

About one-half (49%) reported that their club had an actual audit committee. For those clubs that had an audit committee, the most commonly reported meeting time was annually (33%); another 26% met monthly, 17% met quarterly and another 17% met semi-annually.

For the clubs that had audit committees, 74% responded that their audit committee members were independent, while 18% were not independent and the remaining 8% were unsure. For clubs with audit committees, 98% indicated that at least one member of the audit committee had an accounting or finance background.

The majority (73%) of the clubs with audit committees reported no changes in the structure of the audit committee since the enactment of SOX; however almost 21% did report changes since SOX was enacted. Of the clubs that reported no changes in the structure of their audit committee since the enactment of SOX, almost 85% indicated that their club was not intending to make changes in the structure of the audit committee; only 3% reported that they intended to make changes in the near future.

SOX Related Findings- Board of Directors

Board of Directors SOX findings are shown in Table 3. They reveal that the number of members on the board ranged from three to 36, with a median board size of 12. The most common number of board members were either nine (21%) or 12 (20%). Eleven percent of the clubs had fewer than nine board members, 11% had 10 or 11 members, and 27% had over twelve members. For most of the clubs (88%) the board of directors met monthly, while the vast majority (96%) of the clubs had at least one member of the board that had an accounting or finance background.

Most of the respondents (88%) reported that there had been no changes in the structure of the club's board since SOX was enacted while about the same percentage indicated that the club was not considering making any changes in the structure in the near future.

SOX Related Findings- Internal Controls

The findings relating to internal controls of clubs are summarized in Table 4. That summary indicates that the majority (61%) of the financial executives indicated their club have a formal mechanism for assessing internal controls. For the clubs that did have that mechanism in place, 66% assessed those controls annually while 17% assessed them monthly. For clubs that employ such a mechanism, how important is that mechanism for evaluating the internal controls of the club? Half of the respondents stated that it was somewhat important, 40% indicated that it was very important while the remaining 10% stated that it was either not very important or unimportant. Thus, only 40% of the respondents appear to really understand the importance the SOX Act places on internal control.

SOX Related Findings- External Auditors

External auditor findings are revealed in Table 5. They reveal that about 62% of respondents stated that their club's external auditor issued a separate report on the club's internal controls while about one-third said that no separate report was issued while about 5% stated that they were unsure. Just over one-half of the clubs (51%) reporting indicated that they had made changes in the evaluation or documentation of their internal controls since the enactment of SOX.

Most of the clubs in the survey (94%) had an independent audit conducted with the majority (96%) reporting that it was performed annually. Sixty percent of the respondents stated that their external auditor provided the club with non-audit services. While 72% of the clubs surveyed stated that there had not been any changes to the club's organizational policies with respect to auditors since the enactment of SOX, and most (83%) reported that the club was not considering making any changes to those policies in the near future.

Lastly, the financial executives were asked if they thought that the provisions of SOX should be mandated for all clubs. Somewhat surprisingly, 19% said "yes", 26% were "unsure" while over half (55%) stated "no."

Analysis of Data

Does the size or the profitability of clubs make a difference regarding responses of the financial executives? Chi square analysis was conducted and the results are shown in Table 6.

No significant statistical differences were found between the annual gross revenue of the clubs, the size of the clubs based on number of members, or the profitability of the clubs and the respondents' familiarity with the SOX Act. No significant differences were found between annual gross revenue of the club, the size of the club based on membership, and the clubs' profitability and whether the respondents' clubs had at least one member of the audit committee who had an accounting or finance degree.

Significant differences were found between annual gross revenue of a club, the size based on membership, and the clubs' profitability and whether the club had an audit committee. The larger the club based on gross revenue and membership the more likely that the club had an audit committee. Further, the more profitable the club the more likely the club had an audit committee.

Only the size of clubs based on annual gross revenues and the independence of audit committee members were statistically different. The larger the club the more likely the independence of audit committee members.

Finally, the more profitable clubs have formal mechanisms for assessing internal controls than do less profitable clubs. There were no significant differences based on the size of clubs (whether gross revenues or number of members) and clubs having a formal mechanism for assessing internal controls.

Comparison with Nonprofit Study

The responses to this study were similar in many ways to those in the study of nonprofit organizations conducted by Iyer and Watkins (2008) referenced earlier. In their study 69% of the respondents indicated that they were somewhat familiar or very familiar with the Sox Act compared to 74% in this study. Both studies found that only 49% of the respondents' organizations had an audit committee.

One difference was noted in that about 74% of the respondents in this study stated that all of the club's audit committee members were independent whereas it was 90% in the case of the nonprofit study. When asked whether at least one member of the audit committee had an accounting or finance background, 98% of the clubs indicated "yes" while it was 93% in the case of the nonprofits.

A marked difference was however noted in the question regarding whether the entity had a formal mechanism for assessing internal controls. The club respondents answered "yes" in about 61% of their responses while the nonprofits "yes" response was 78%. A similar difference was noted between the responses in the two studies regarding whether the external audit firm provided any non-audit services. Sixty percent of the respondents in the club study said "yes" whereas only 42% of the nonprofit respondents responded in the affirmative. The biggest difference between the two groups had to do with whether or not the SOX provisions should be mandated for all clubs and for all nonprofits. Only 19 % of the clubs said yes while 36% of the nonprofits said yes to that question.

Conclusions, Limitations and Recommendations

Just over 58% of the financial executives responding to this survey indicated they were somewhat familiar with the SOX Act. Though clubs are not required to follow SOX, a number of states have passed financial reform laws covering not for profit organizations and this trend may well continue. Therefore, it behooves club financial executives to increase their knowledge of SOX and similar laws.

Though many clubs (74%) with audit committees have independent members and virtually all (98%) of these committees have at least one audit committee member with an accounting or finance background, only 49% of the clubs have an audit committee. We strongly encourage the remaining 51% to form an audit committee to provide financial oversight.

The average respondent's club had 685 members while the average size of the board of directors was 12. Thus, on average clubs have one board member for every 57 members. This seems reasonable still 11% of the clubs have less than nine board members. We suggest these clubs consider enlarging their boards to insure greater representation of their members.

A majority of only 61% have a formal mechanism for evaluating internal controls and the controls are evaluated only annually by 66% of these clubs. These apparent gaps are overset in part as virtually all clubs have an external audit which will include an extensive evaluation of the clubs' systems of internal controls. Still we urge the 39% without a formal mechanism for evaluating internal controls to be proactive and establish assessment procedures. Further, overall financial executives should enhance their knowledge as only 40% appear to understand the importance placed on internal controls by SOX.

Finally, 94% of the clubs have an independent audit but only about 62% receive a separate report on their clubs internal controls. We recommend that all clubs have an independent audit and that the auditors provide to each club a separate report on internal controls of the club audited. Any weaknesses in internal controls of the club are thereby brought to the attention of each clubs' board of directors, audit committee, and top financial executive. Weaknesses in internal controls can thereafter be corrected enhancing the financial integrity of the club and its financial statements.

Limitations

This study is based on the responses of 179 financial executives of private clubs from a sample of 1000 financial executives of clubs associated with HFTP. There are over 4000 private clubs in the U.S. thus it is possible that our findings are biased by the financial executives of clubs belonging to HFTP. The research is limited in evaluation of clubs and the SOX art in that this research focused on four major areas though the SOX Act has 11 sections.

Future Research

Future research could include surveying club financial executives regarding the remaining sections of the SOX Act not covered by this research. Additional research should be conducted to determine the extent to which the restaurant and lodging segment of the hospitality industry is in compliance with the SOX Act. Comparisons could then be made among all three segments of the industry.

Benefits of this Study

Both the club industry and hospitality academy should benefit from this research. First, the club industry financial executives are informed of the need for improvement in many of their clubs in the four areas of audit committees, boards of directors, internal controls, and external audits. Further, they gain greater understanding of the SOX Act based on the discussion in this paper.

The hospitality educators teaching either managerial accounting or club management should benefit in two ways. First, they are provided with the overall results of this research. For example, what is the size of the board of the average club and how do club financial executives regard importance of their formal mechanism for evaluating internal controls. Further, they are able to teach their students that there are numerous short comings in many clubs shown by this research and then suggest improvements in the club industry.

Table 1
Demographic Data

1. Current position of respondent:

Controller	62.0%
CFO	21.2
Business Manager	0.6
Other	16.2
Total	100%

2. Best description of club:

Country Club	68.7%
City Club	9.5
Athletic Club	1.7
Yacht Club	5.0
Other	15.1
Total	100%

3. Size of club in annual revenue:

< $1,000,000	1.7%
$1,000,000-2,000,000	2.8
$2,000,000-3,000,000	4.5
$3,000,000-5,000000	24.0
$5,000,000-10,000,000	36.8
> $10,000,000	30.2
Total	100%

4. Size of club in members:

< 250	3.4%
250-500	28.3
501-750	24.2
751-1000	16.9
1001-2000	16.9
> 2000	10.3
Total	100%

5. Profit vs. Not-for-Profit:

Not-for-Profit	91.1%
Profit Oriented	8.9
Total	100%

6. Profitability of clubs:

Loss greater than $100,000	27.6%
Median Net income of $23,044 to loss of $100,000	22.8

Net income $23,044 to $300,000	24.8
Net income greater than $300,000	24.8
Total	100%

Table 2
SOX Related Findings-Audit Committee

1. Respondent's familiarity with the Sarbanes-Oxley Act of 2002

Not familiar at all	5.6%
Not very familiar	20.8
Somewhat familiar	58.4
Very familiar	15.2
Total	100%

2. Percent of clubs with an audit committee

Yes	48.9%
No	51.1
Total	100%

3. Club's audit committee meeting schedule

Monthly	26.2%
Quarterly	16.7
Semi-Annually	16.7
Annually	33.3
Other	7.1
Total	100%

4. Independence of club's audit committee members

Yes	74.2%
No	17.6
Unsure	8.2
Total	100%

5. At least one member of club's audit committee has an accounting or finance background

Yes	97.6%
No	1.2
Unsure	1.2
Total	100%

6. There have there been changes in the structure of the club's audit committee since SOX was enacted

Yes	20.9%
No	73.3
Unsure	5.8
Total	100%

7. If there were no changes to date, club is considering making changes in the near future

Yes	3.4%
No	84.7
Unsure	11.9
Total	100%

Table 3
SOX Related Findings- Board of Directors

1. Club's board of directors meeting schedule

Monthly	88.4%
Bimonthly	2.3
Quarterly	2.9
Semi-Annually	0.6
Annually	0.6
Other	5.2
Total	100%

2. At least one member of club's Board of Directors has an accounting or finance background

Yes	96.0%
No	1.1
Unsure	2.9
Total	100%

3. There been changes in the structure of club's Board of Directors since SOX was enacted

Yes	6.3%
No	88.0
Unsure	5.7
Total	100%

4. The club is considering making changes in the near future

Yes	1.4%
No	87.1
Unsure	11.5
Total	100%

Table 4
SOX Related Findings-Internal Controls

1. The club has a formal mechanism for assuring internal controls

Yes	60.7%
No	39.3
Total	100%

2. Schedule of assessment for internal controls

Monthly	16.7%
Quarterly	7.4
Semi-Annually	8.3
Annually	65.7
Other	1.9
Total	100%

3. Importance of a formal mechanism for evaluating the internal controls within club

Unimportant	1.1%
Not very important	8.6
Somewhat important	50.1
Very Important	40.2
Total	100%

4. Internal auditor issues separate reports on internal controls

Yes	61.6%
No	33.3
Unsure	5.1
Total	100%

5. Changes in the evaluation or documentation of internal controls since the enactment of SOX have been made

Yes	51.4%
No	43.5
Unsure	5.1
Total	100%

Table 5

SOX Related Findings-External Auditors

1. Club has an independent audit conducted

Yes	93.8%
No	6.2
Total	100%

2. Occurrence of independent audit

Annually	96.3%
Every three years	0.6
Every five years	0.6
Semi-Annually	2.5
Total	100%

3. Auditor also provides non-audit services

Yes	60%
No	40
Total	100%

4. Changes to club's organizational policies with respect to auditors since the enactment of SOX have been made

Yes	17.5%
No	72.3
Unsure	10.2
Total	100%

5. Club is considering making changes to organization's policies in the near future

Yes	2.4%
No	83.1
Unsure	14.5
Total	100%

6. Provisions of SOX should be mandated for all clubs

Yes	18.9%
No	54.8
Unsure	26.3
Total	100%

Table 6

Chi-Square Factors for Size and Profitability of Clubs and Responses to Selected Questions

	Size of Clubs		
	Gross Revenue	Number of Members	Profitability of Club
Familiarity with SOX	6.495	7.056	12.419
Existence of an audit committee	15.731*	32.012*	14.762*
Independence of audit committee members	10.915**	7.974	7.961
Audit committee member-financial management background	3.455	4.823	4.403
Formal mechanism for assessing internal controls	3.466	2.255	9.784**

* Significant at <1%.
** Significant at < 5%.

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