Sarbanes-Oxley Raises the Bar for Private Companies

By Joseph Kubarek

The Sarbanes-Oxley Act of 2002 was designed to prevent unscrupulous business behavior and call a halt to questionable financial reporting. The law generally limits its scope of applicability to public companies—corporate issuers of securities regulated under the Securities Exchange Act of 1934. However, certain provisions are directly applicable to companies that are not publicly traded and the indirect and long-term effects of the reforms will almost certainly affect private companies, particularly in the areas of accounting and corporate governance.

The enhanced accountability standards that Sarbanes-Oxley established for public companies have effectively raised the bar for corporate governance and business practices of private companies. Stakeholders will increasingly insist on compliance with at least certain Sarbanes-Oxley standards as a prerequisite to initiating or continuing relationships with both public and private companies. Shareholders, the public, and courts will likely hold boards of directors and their committees to higher standards of performance. Furthermore, governmental and industry governing bodies have begun to propose statutes and regulations that will require private companies to step up and tighten their corporate governance practices. As a result, it is paramount that private companies take the initiative to examine their corporate governance and business practices under a Sarbanes-Oxley microscope and establish enhanced internal standards for accountability, independence, disclosure, integrity, and oversight where existing policies and practices appear to fall short.

Director Summary: Sarbanes-Oxley, while primarily aimed at public companies, has raised the bar of corporate governance for private companies as well. Examine your current practices; create a code of ethics; move toward compliance with conflict of interest and audit committee provisions; and establish policies of transparency and disclosure.

Direct Federal Influence

Provisions that directly apply to both public and private companies include:

- ***Section 802.*** Makes it unlawful to knowingly alter, destroy, mutilate, conceal, or falsify documents, records, or tangible objects with the intent to impede, obstruct, or influence any federal investigation or bankruptcy proceeding and provides for the imposition of fines, imprisonment up to 20 years, or both, for a violation of the statute.
- ***Section 904.*** Increases the maximum criminal monetary penalties for violation of the reporting and disclosure provisions of the Employee Retirement Income Security Act of 1974 from $5000 to $100,000 for individuals and from $100,000 to $500,000 for entities and increases the maximum prison sentences from 1 year to 10 years.
- ***Section 1107.*** Provides for imposition of a fine, imprisonment for up to 10 years, or both, for anyone who "knowingly, with the intent to retaliate, takes any action harmful to any person, including interference with lawful employment or livelihood of any person," for providing law enforcement personnel with truthful information relating to the commission or attempted commission of any federal offense and for a violation of the statute.

Best Practices for Private Companies

In light of the far-reaching effects of Sarbanes-Oxley with respect to accounting standards and the corporate governance arena, private companies should commit themselves to playing by the Sarbanes-Oxley rules. The following list of Sarbanes-Oxley best practices is modeled on the guidelines provided by the FDIC in its March 2003 financial institution letter and provides a solid framework that private companies may use to improve their business and accounting policies and practices:

Shareholders, the public, and courts will likely hold boards of directors and their committees to higher standards of performance.

• Use independent internal and external auditors whenever cost-effective and where the same external auditor performs both external and internal audit functions. The audit committee should document both its preapproval of the internal audit outsourcing to its external auditor and that it has considered the independence issues associated with this arrangement.

• Use audit partner rotation and "time out" periods when engaging an accounting firm that is not a small firm (i.e., a firm with 10 or more auditors) to perform its external audit functions.

• Communicate in the engagement letter with the auditor: (1) all critical accounting policies used by the auditor; (2) alternative accounting treatments that the accounting firm has discussed with the company's management and the potential ramifications of using those alternatives, as well as the treatment preferred by the accounting firm; (3) other written communication the accounting firm has provided to the company's management, such as a management letter or schedule of unadjusted differences—to provide for effective communication between the external auditor and the company's audit committee.

• Comply with the Sarbanes-Oxley conflicts of interest requirement, which prohibits the company's use of an accounting firm if the company's chief executive officer, controller, chief financial officer, chief accounting officer, or equivalent officer was employed by the accounting firm during the one-year period before the beginning of the audit.

• Establish procedures for the audit committee's processing of complaints and employee submissions regarding questionable accounting, internal accounting control, or audit matters and procedures, for the timely investigation of complaints received and the retention of a reasonable time period of documentation regarding the complaint and its subsequent resolution.

• Establish policies providing that no officer or director or anyone acting under their direction may mislead, coerce, manipulate, or fraudulently influence an external auditor preparing an audit report for the purpose of rendering it materially misleading.

• Provide for disclosure of all material correcting adjustments identified by external auditors and, where the company issues audited financial statements, disclosure of material off-balance-sheet transactions to ensure that examiners and other users of the financial statements are aware of them and can include them in their evaluation of the condition and risk profile of the company.

• Consider the costs and benefits of supplementing the audit with an internal control assessment by management and the company's independent public accountant's attestation of this assessment.

• Adopt a code of ethics for senior financial officers and periodically disclose the existence of the code of ethics, or lack thereof, to shareholders.

Conclusion

Sarbanes-Oxley created "best practices" that privately held for-profit and not-for-profit companies should follow, regardless of whether the activities are currently required under applicable laws. Key business partners will more closely scrutinize accounting and corporate governance practices and will increasingly demand compliance with Sarbanes-Oxley requirements. In order to comply with these enhanced standards, private companies should carefully review their existing practices, and where necessary, take action to establish:

- A competent and reliable board of primarily independent directors.
- An office of the chairman of the board.
- An effective and working audit committee, nominating or corporate governance committee, and compensation committee.
- An effective board compensation policy.
- Procedures for succession of the board of directors.
- Requirements for directors' continuing education.
- Corporate governance standards that are designed to enhance shareholder value.
- Formal disclosure controls and policies and procedures to ensure that public disclosures are accurate and complete.
- Independence among internal auditors and external auditors whenever determined to be cost-effective.
- A code of conduct and business ethics.
- A corporate culture that is based on principles of open communication, transparency, accountability, and commitment to carrying out the duties of care and loyalty. ■

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