

## Why (do) private companies comply with the Sarbanes-Oxley Act?

Emily Strehlow  
St. Norbert College

Crystal Flasch  
St. Norbert College

Amy Vandenberg  
St. Norbert College

Jason Haen  
St. Norbert College

### ABSTRACT

In today's business world, the Sarbanes-Oxley Act (SOX) of 2002 plays a major role in everyday business activities. The passage of SOX was the result of the financial implosions well-known companies such as Enron and WorldCom due to unethical practices and inadequate corporate governance. SOX was introduced to prevent these types of fallouts from happening in the future.

Even though some public companies who are required to comply with SOX are finding it financially burdensome, a number of private companies choose to comply with various provisions. If some public companies consider the cost of compliance to be onerous, the question is why private firms would even bother to comply with SOX at all?

What is motivating private companies to comply with SOX? Do the benefits outweigh the costs? Is compliance really voluntary or are private companies being forced to comply with provisions of SOX in order to appease external and internal parties? This study researched pertinent literature and conducted interviews with various private companies to gain an understanding about if and why some private companies choose to comply with provisions of SOX.

Keywords: Sarbanes-Oxley Act, compliance, private companies, corporate governance.

## INTRODUCTION

At the turn of the 21<sup>st</sup> century the historic crash of Enron shocked people around the world. Due to the unethical accounting techniques and lax corporate governance by Enron and many other companies, like WorldCom, the Sarbanes-Oxley Act (SOX) of 2002 was enacted. While SOX currently applies only to publically traded companies, many are wondering when copy-cat laws imposed at either the federal or state level will affect the private sector.

While privately-held companies currently are not required to comply with SOX, there may be pressures for compliance from within the marketplace as SOX has become the benchmark against which every company's financial reporting and corporate governance practices are measured. Any SOX compliance by private companies may result in additional costs including hiring employees, outside auditors, technology upgrades, etc. Do private companies believe that the benefits of complying with SOX outweigh its costs? This study of why private companies comply with SOX (partially, entirely, or not at all) aims to answer this question through researching articles and conducting interviews with various privately-held companies.

## PURPOSE OF SOX AND COSTS OF COMPLIANCE

SOX was signed in 2002 by President Bush to provide "unprecedented new requirements for auditors of public companies, publicly-held companies, and Wall Street" (Reed, Buchman, and Wobbekind, 2006, p. 25). Under the provisions of SOX, most public companies are required to establish, document, and assess various internal controls and procedures for financial reporting. External auditors also must now give an opinion about the adequacy of the company's internal control structure in addition to an opinion about the financial statements. Furthermore, both the CEO and CFO have to personally attest to the accuracy of the company's financial statements. It is hoped that these and other provisions will benefit the market by increasing investor confidence in the financial statements of public companies.

Public companies also report operational benefits related to SOX compliance. According to a survey conducted by Protiviti (2011, p.13), 56% of respondents reported that SOX compliance enhanced their understanding of control design and effectiveness, 49% reported that compliance increased effectiveness and efficiency of operations, and 37% indicated that compliance enhanced their ability to identify duplicate and unnecessary controls. Only 14% of companies reported they perceived no benefits related to SOX compliance and were only complying because it was mandated.

The benefits associated with SOX compliance have come at significant costs, which are a major concern for public companies. According to a survey conducted by Financial Executives International, companies with over \$5 billion in revenues reported implementation costs of \$4.6 million while smaller companies estimated their implementation costs to be almost \$2 million (D'Aquila, 2004). However, ongoing compliance costs do appear more manageable for companies. "By Year Four of complying with Sarbanes-Oxley, most organizations spend in the range of \$100,000 to \$1 million annually on compliance depending on size" (Protiviti, 2011, p. 3).

The significant difference between implementation and ongoing compliance costs appears to affect how companies respond when asked if the benefits of SOX compliance exceed

its costs. When asked about their year of implementation, only 43% of companies report that they believe that the benefits related to SOX compliance exceeded its costs (Protiviti, 2011, p. 11). However, in regard to the current year of compliance, 67% reported that the benefits outweigh the costs (Protiviti, 2011, p. 11).

## **PRIVATE COMPANY COMPLIANCE**

Privately-held companies currently are not required to comply with SOX, but it has been suggested that companies that may be considering going public or may be acquired by a public company may receive a premium for being SOX compliant (Savich, 2006). Overall a small percentage of all privately-held companies fall into these categories, so if a significant number of privately-held companies are complying with SOX there must be some other expected benefits or outside pressures compelling them.

There have been a number of surveys conducted to determine if and why privately-held companies comply with SOX. For example, in a survey conducted by Reed, Buchman, and Wobbekind (2006), responses indicating implementation or consideration of implementation of specific corporate governance practices contained in SOX ranged from 34% to 66%. Over 50% of respondents indicated that possible benefits of voluntary compliance included establishing stronger business credit, the potential for better major financing options and enhancing credibility with key stakeholders. Outside pressure to comply with provisions of SOX was reported by only about 30% of the respondents. Participants also indicated that high costs and no specific benefits were two reasons why other specific provisions were not implemented. Selected results of the survey are contained in Table 1 (Appendix).

A study by Foley & Lardner LLP (2006) reports even higher rates in regard to the percentage of privately-held companies who comply or are considering complying with various provisions of SOX (38% - 88%). Specific potential benefits were not presented as part of the survey, but only 32% of participants indicated that the benefits of additional corporate governance exceed the related additional costs. Reasons for adopting new corporate governance policies included pressure from outside auditors (36%) and board members (46%). The study concluded that the provisions most likely to be implemented were those that can be done at the lowest cost. The results for a number of the specific corporate governance practices included in the study are presented in Table 2 (Appendix).

## **COMPANY INTERVIEWS**

These surveys indicate a fairly high level of compliance with various provisions of SOX by privately-held companies. However, surveys do not allow for opportunities for immediate follow-up questions which may provide more specific information about the timing, degree and reasons for compliance. For example, even though participants indicate the potential for a certain benefit, this benefit may not be the primary reason why a privately-held company is complying with a specific provision of SOX. Therefore, in order to gain more in-depth knowledge about the reasons why and if privately-held companies comply with various provisions of SOX, four privately-held companies were contacted to request interview sessions.

Each company was provided the set of questions prior to the interview (the questions are included in the Appendix). The interviews were conducted by phone between August 9, 2012 and October 16, 2012. The companies range in size from \$500 million to \$3.5 billion of

revenues and represent four distinct industries. Company names are not included in this report per the request of the respective companies.

A common thread between all companies interviewed was that each company, to some extent, was compliant with various provisions of SOX. However, the companies mainly had these controls in place prior to SOX. Most of the companies had not made significant changes because of the passage of SOX, but had implemented specific policies prior to SOX because they had recognized them as good corporate governance.

All of the companies did note that the focus of the external auditors has changed since SOX was enacted. Internal controls are more of a consideration for the external auditors and thus more employees are involved during the audit process. This has occurred even though none of the companies have the auditors complete an integrated audit which would have the auditors express opinions about the financial statements and the internal control structure of the company. At least for these four companies, SOX appears to have indirectly required them to focus more on their internal control structures. This is especially evident in the company that has recently established an internal audit function.

Additionally, some of the external auditors used by the companies have required the CEO/CFO to attest to the accuracy of the financial statements. How formalized this process is appears to depend on the auditing firm used versus the desires of the company. It may be that auditing firms with a strong public presence have simply instituted this as a best practice for all of their clients without regard of whether they are publicly or privately held.

One aspect that did vary between the companies was the establishment of whistleblower procedures. Whistleblower procedures are formal channels employee can follow to report ethical concerns they note within a company. One company has a very detailed whistle blowing policy in place. While another company did not currently have a procedure in place but hoped to establish one in the near future. Two companies had no intentions of establishing a whistleblower program. They believe that the culture present in their company already promotes the reporting of ethical concerns so a formalized process is not needed.

Another noticeable difference within each company was the extent of their ethical code of conduct. Once again one company had a very detailed code of conduct which must be resigned annually by employees. Another company always had a ethical code of conduct and had no plans to revisit it. One company has drafted an ethical code of conduct based on a request from their board of directors and hoped to have it implemented next year. The last company has not adopted a formal ethical code of conduct and does not feel it is necessary due to their corporate culture.

The presence and structure of audit committees also varied by company. Three out of the four companies indicated they had audit committees. All the companies with audit committees indicated at least one member would fit the definition of a “financial expert” as described by SOX. The rest of the make-up of the audit committees varied with some being dominated by internal parties.

It should be noted that the company which indicated the most SOX compliance was once publicly-held and acknowledged public holding to be a possibility in the future. Initial compliance work for this company was in the \$50,000 – \$100,000 cost range and primarily consisted of external consultants. This company’s investment in its initial thrust towards compliance and the potential to be publicly-owned in the future appear to be the primary reasons why it complies with more provisions of SOX than the other companies interviewed. Additionally, this company had the most positive opinion about SOX. Mirroring SOX as much

as possible is something the company believes is the fiscally responsible thing to do. They believe SOX compliance is something companies/business should have been doing all along. The interviewee stated, "It merely is something that should have been complied to all along; it has structure, enforces internal controls, provides consistency, and allows companies to be on the same playing field."

## **CONCLUSION**

While SOX was intended to impact only public companies, it would be naive to conclude that SOX has not impacted other parts of the economy. All of the privately-held companies interviewed were well aware of the provisions of SOX. While a quantifiable cost of compliance in most cases could not be stated, what was obvious was the newly heightened focus on internal controls and corporate governance both by the companies and their external auditors.

The privately-held companies interviewed exhibited the high compliance rates of past surveys, but much of the compliance was in place before the passage of SOX. These companies recognized well before SOX that many of its provisions were good corporate governance and did not have to be forced by outside entities to implement them.

All companies interviewed, despite size and industry, appear to be on board in theory with SOX regulations. While at times compliance seemed to be nothing more than an afterthought, all companies interviewed recognize the need for adequate internal controls and corporate governance. However, further intervention by the government into the operations of privately-held companies appears to be an unwelcome possibility.

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**APPENDIX**

Table 1: Specific Corporate Governance Practices of Private Companies

Governance Policy	Implemented or Considering Implementation
Formal certification of financial statements	49%
A policy on whistleblower situations	49%
A code of professional conduct for the CEO and other financial management	69%
An independent audit committee	52%
Guidelines to establish a financial expert on the audit committee or Board Directors	40%

(Reed et al., 2006, p. 30)

Table 2: Specific Corporate Governance Practices of Private Companies

Governance Policy	Implemented or Considering Implementation
CEO/CFO financial statement attestation	59%
Establishment of whistle-blower procedures	70%
Establishment of a corporate ethical code	88%
Establishment of an audit committee separate from the finance committee	66%
Addition of a financial expert on audit committee	68%

(Foley &amp; Lardner LLP, 2006, p. 8)

## Interview Questions

### General Questions

1. Does your company currently comply with any of the provisions of SOX? Why?  
Implemented before SOX was enacted?  
Required by outside parties? (creditors, customers, etc.)  
Required by inside parties? (investors, board members, etc.)  
Reputation?
2. Who in the company is primarily responsible for ensuring that the company remains compliant (internal auditing)?
3. Was your company required to add staffing to become compliant? Did your company calculate these costs? Were there any additional costs besides staffing? Have advances in technology affected any of the costs to become/remain compliant?
4. What benefits do you see in being compliant with SOX?  
Do you believe these benefits outweigh the costs?

Specific Questions (these may not need to be asked depending how question one is answered and how much detail is given)

5. Does your company have an ethical code of conduct? Why or why not?
6. Has your company formally adopted whistle-blower procedures? Why or why not?
7. Does your company formally require the CEO and CFO to attest to the fairness of financial statements? Why or why not?
8. Does your company have your financial statements externally audited? Why or why not?
9. Does your company have your internal controls externally audited? Why or why not?
10. Does the company have a separate audit committee? Why or why not?  
Does the audit committee include a “financial expert” as described by SOX?  
Does the audit committee oversee the auditors?
11. What, if any, is the role of the board of directors with SOX compliance?  
Does the board approve all non-audit services provided by external auditors?

### Concluding Questions

12. Has the company ever consider being publicly traded? If so, was full SOX compliance part of the discussions?
13. Do you believe there will be any future changes to SOX that may affect your company?
14. Is there anything else about SOX that you would like to share with us?