Fallout from the Sarbanes-Oxley Act – are Private Companies and Nonprofits Next?

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ABSTRACT:

The American Competitiveness and Corporate Accountability Act of 2002, commonly referred to as the Sarbanes-Oxley Act (SOX), was legislated in response to corporate fraud and the resulting perception of an emerging imbalance between the investing public and publicly held companies. This paper reviews other initiatives concerned with corporate governance and some of the major provisions of SOX. Costs of compliance as well as benefits are addressed The impact of SOX on smaller public companies, including companies going private or dark, is discussed. The paper concludes with a look at the implications for not-for-profit organizations such as hospitals and universities.

Keywords: Sarbanes-Oxley, SOX, Fraud, Governance, Not-for-profit

INTRODUCTION

The American Competitiveness and Corporate Accountability Act of 2002, commonly referred to as the Sarbanes-Oxley Act (SOX) was written in response to egregious corporate violations of investor trust (Enron, WorldCom, Adelphia). SOX drew immediate attention to itself by the extent of its reforms and by the fact that it was a piece of federal legislation imposed on the parties to a basic trust relationship between the general investing public and publicly held companies. In part because of this visibility, SOX is poised to serve as a *de facto* standard even for those organizations that are not legally bound by its provisions.

OTHER INITIATIVES

SOX is not the first legislation concerned with corporate governance. There have been other initiatives in the United States and abroad. The Foreign Corrupt Practices Act (FCPA) of 1977, which was substantially revised in 1988, prohibits the bribery of foreign government officials by U.S. persons and prescribes accounting and record-keeping practices. The anti-bribery provisions of the FCPA apply to any U.S. person and make it illegal for U.S. persons to bribe a foreign government official for the purpose of obtaining or retaining business. The accounting and record-keeping provisions of the FCPA apply to companies that are publicly traded in the U.S. These provisions make it a requirement for such companies to devise and maintain an accounting system that tightly controls and accurately records all dispositions of company assets.

There has also been activity internationally. In the early 1990s, the United Kingdom explored governance reform through the adoption of the Cadbury Code (later, the Combined Code). In 1999, the Paris-based Organisation for Economic Co-operation and Development (OECD) published its *Principles of Corporate Governance* as a benchmark for policy-makers, corporations and others. The China Securities Regulatory Commission has been implementing a code of corporate governance practices, *The Code of Corporate Governance for Listed Companies in China.* South Africa adopted the *King Report on Corporate Governance for South Africa – 2002,* which provides a governance framework for companies listed on the Johannesburg Stock Exchange. The European Union (EU) has issued a phased action plan to underscore its claim to regulate the corporate governance and audit standards of EU companies (Green and Gregory, 2005).

APPLICABILITY AND TIMING

SOX was written for public companies. A few provisions, including whistleblower protection and document retention, apply to all companies and nonprofit organizations. Specific effective dates are in place. Accelerated filers (issuers with a public float of $75 million or more as computed on the last business day of the issuer’s most recently completed second fiscal quarter) were given an extension to the Form 10-K filed in late 2005 or early 2006. In 2005, the SEC gave smaller companies and foreign companies until July 15, 2006, to meet the requirements to file reports on the strength of their internal financial controls (“SEC gives …,” 2005).

MAJOR PROVISIONS

Section 302, which deals with CEO and CFO assertions regarding financial reports, and section 404, which refers to internal controls, have received the most coverage in the media. There are, however, several significant provisions of the Act.

Section 101 created the Public Company Accounting Oversight Board to oversee SOX and public accounting firms.

Section 201 made it unlawful for public accounting firms to provide specified non-audit services to audit clients. It will not be unlawful to provide other non-audit services if they are pre-approved by the audit committee and if the audit committee discloses to investors in periodic reports its decision to pre-approve non-audit services.

Section 203 requires the lead audit or coordinating partner and the reviewing partner to rotate off of the audit every 5 years.

Section 206 states that the CEO, Controller, CFO, Chief Accounting Officer or person in an equivalent position cannot have been employed by the company's audit firm during the 1-year period preceding the audit.

Section 301 requires that audit committee members be independent and members of the board of directors. This section also requires the audit committee to establish procedures for the confidential, anonymous submission by employees of questionable accounting or auditing matters.

Section 302 states that the CEO and CFO shall prepare a statement to accompany the audit report to certify the "appropriateness of the financial statements and disclosures contained in the periodic report, and that those financial statements and disclosures fairly present, in all material respects, the operations and financial condition of the issuer."

Section 402 prohibits personal loans to directors and executives.

Section 404 requires each annual report of an issuer to contain an "internal control report," which shall: (1) state the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting; and (2) contain an assessment, as of the end of the issuer's fiscal year, of the effectiveness of the internal control structure and procedures of the issuer for financial reporting. Each issuer's auditor shall attest to, and report on, the assessment made by the management of the issuer.

Section 406 requires each company to disclose whether it has adopted a code of ethics for its senior financial officers and the contents of that code.

Section 407 requires each company to disclose whether at least one member of its audit committee is a "financial expert."

Section 802 addresses document retention.

COSTS OF COMPLIANCE FOR PUBLIC COMPANIES

A primary criticism of SOX is the cost of compliance. Section 404 is considered to be the most costly provision of the Act. Internal controls have to be documented and management must assess their effectiveness. The external auditors are required to attest to management's assessment. The internal auditing community has gotten very involved and software vendors have developed materials to assist companies comply. The firm that is auditing the company's financial statements can not provide internal control–related services, which has led to companies bringing in other public accounting firms and other consultants to provide support to comply with 404.

A Financial Executives Institute survey determined average costs for complying with SOX section 404. Companies with less than $100 million in revenue – $558,674; $100 to $500 million – $826,655; $500 million to $1 billion – $1,077,970; $1 to $5 billion – $2,377,460; more than $5 billion – $8,062,520 (Anonymous, 2005). The costs have been increasing, as reported in a 2005 survey conducted by the Business Roundtable, an association of CEOs of 160 leading U.S. companies. Those survey results reflected a steep increase in reported costs of implementing SOX and new stock exchange listing standards. Forty-seven percent of respondents reported costs of more than $10 million as compared to 22% in 2004. One third of respondents reported costs of $6-$10 million ("New Business…," 2005).

As companies are starting to report on internal controls, deficiencies are being disclosed. An article in *Business Week* estimates that 10-20% of companies will probably report problems tracking their internal accounts (Henry, 2005). According to the *Wall Street Journal*, more than 500 companies have reported deficiencies with their internal accounting controls (Solomon, 2005). Sun Trust Banks Inc., Atlanta, is disclosing a material weakness in their report. Toys "R" Us Inc. disclosed that it was working to resolve internal control issues. Kodak expects an adverse opinion citing material weaknesses in its internal financial controls for 2004. (Bulkeley and Tomsho, 2005). The question that some are raising is "What is going to happen when we have an accounting failure for a company with a clean opinion on 404?"

BENEFITS TO PUBLIC COMPANIES

SOX has brought some benefits to companies. The Act's requirements are considered best practices that can result in better corporate governance and transparency. Audit committees and boards are getting more involved. Controls are being evaluated and improved. Working on SOX may even help companies move toward an enterprisewide risk model.

The Business Roundtable survey found that 95% of respondents have seen an increase in the number or length of Audit Committee meetings, or otherwise have seen more involvement by committee members in the past two years. ("New Business…," 2005). A survey completed by 222 financial leaders that is cited in *Strategic Finance* indicated that 74% of respondents have benefited from compliance. Seventy-nine percent of financial executives say their companies have stronger internal controls as a result of complying with SOX. Forty-six percent say SOX compliance ensures the accountability of individuals involved in financial reports and operations. Thirty-three percent mention a decreased risk of financial fraud and 31% say reduced errors in financial operations. Twenty-seven percent note improved accuracy of financial reports; 25% say it empowers the audit committee by providing it with deeper information; 20% say it strengthened investors' views of the company (Williams, 2005).

The authors of an *Internal Auditor* article suggest leveraging the investment in SOX to implement enterprisewide risk management (ERM). Companies that are complying with SOX have a process and staff in place to document and evaluate internal controls; they can now go enterprisewide. They can now focus on operations risk rather than financial risk. An ERM solution normally takes two to three years. The SOX work already completed, especially in establishing a COSO framework, can significantly reduce that time (Matyjewicz and D'Arcangelo, 2004).

IMPACT ON SMALLER PUBLIC COMPANIES

Smaller companies were given an extension to comply with section 404. This was driven not only by the difficulty and cost of documenting and assessing internal controls by management, but also by the unavailability of auditors to attest to management's assessment. The internal control attestation has added a significant amount of work to public accounting firms that must include this in their annual financial statement audit. In addition, public accounting firms are busy getting involved with non-audit clients who need help documenting and evaluating their internal controls.

Smaller companies are not being serviced by big four firms. Ernst & Young didn't have enough people to handle the "mountain of extra work" created by the legislation. All Big Four firms have increased the amount of work they must do for clients and the fees they charge (Browning, 2005).

PUBLIC COMPANIES GOING PRIVATE AND GOING DARK

A company goes private when it reduces the number of shareholders to fewer than 300 and is no longer required to file reports with the SEC. There are several methods of going private – doing a self tender for outside shares, doing a squeeze out merger with a newly formed corporation, and declaring a reverse stock split to reduce the number of shares and shareholders (Perry, 2005).

In the 1990s, the number of companies going private was in the single digits. In 2001 the number was 66; 75 in 2002; 95 by July 2003. Going private transactions are running at a rate of 20-30% of IPOs in the 2000s. The cost of being public, which on average went from $900,000 to $1,954,000 post SOX, is the number one reason given by smaller firms. Expensive audits, premiums for officer and director insurance, and higher fees to outside directors (at least three outside, one financial expert) are contributing factors. The cost of going private of between $50,000 and $100,000 is relatively low (Block, 2004).

A 2004 *Boston Globe* article referenced Grant Thornton's findings that privatization transaction announcements jumped 30% to 120 in the period since SOX was signed into law on July 30, 2002, compared with the prior 16-month period. In addition to legal, accounting, auditing, and registration fees increasing, companies also now face an increased risk of shareholder litigation (Weisman, 2004).

Hundreds of small companies are going dark, or voluntarily deregistering shares. Firms that go dark delist their shares and deregister with the SEC. Deregistered companies do not have to file annual and quarterly reports with the SEC. There is no need for audits and no need for executives to certify the accuracy of financial results. They are still publicly traded companies and they still have shareholders unless the shareholders choose to sell their shares. Companies who do this must have fewer than 300 shareholders of record (500 for companies with less than $10 million in assets). Going dark is easier and less expensive than going private and shareholder approval isn't needed. A Wharton study found nearly 200 firms went dark in 2003, up from 30 in 1999. The researchers estimated 134 for 2004 (Burns, 2005). Most of the companies going dark will still be listed on the pink sheets that provide pricing and financial information for over-the-counter stocks. According to Alexander J. Triantis, associate professor at the University of Maryland, about 200 companies petitioned to delist in 2003. In 2002, just 67 went dark (Deutsch, 2005).

SOX IMPACT ON PRIVATE COMPANIES

Private companies, which are not subject to SOX, are reevaluating the decision to go public. They do not welcome the extra costs and scrutiny. They are, however, voluntarily adopting some of the less expensive provisions and may be beneficiaries of a renewed look at financial reporting rules for private companies. According to Ted Flynn, executive director of the Massachusetts Society of CPAs, the passage of SOX has prompted a closer look at financial reporting for private companies (Big GAAP- Little GAAP) (Fineberg, 2004).

Fewer private companies are going public. The number of S-1 filings (IPO), according to the SEC, may reach an eight-year low in 2003. Only 234 private companies filed S-1 forms as of September 12. More than 1000 private companies sought to go public in 2002. SOX is one factor. Prohibitions for external auditors regarding services they can provide and the requirement to have financial expertise on the audit committees are having some affect (Eufinger, 2003).

A study by Foley & Lardner LLP found that private organizations are adopting relatively less expensive reforms including CEO/CFO certification, election of independent directors, development of ethical codes and approval of non-audit services by the board. They also found that customers and insurance companies are emerging as stakeholders ("Foley…," 2005). Compliance is becoming a reporting and governance best practice, according to SOX consultants. They claim than non-compliant companies may be setting themselves up for negligence suits, should they ever suffer large financial frauds (Anonymous, 2005).

SOX IMPACT ON NONPROFITS

Not-for-profit organizations are not subject to SOX, but those that do not hold themselves to the SOX standards may be perceived as having betrayed the trust of their communities. Senate Finance Committee Chairman Charles E. Grassley, R-Iowa, has spearheaded Congressional efforts to require SOX regulations among nonprofits. Grassley believes that there exists "a mind set that doesn't put donors and the needy first, just as corporations didn't put employees and shareholders first" (Merli, 2004).

Even if federal legislation is not passed, not-for-profits will likely feel affects of SOX. A study by Foley & Lardner LLP found that 97% of nonprofit groups reported an impact of SOX on their organizations. Eighty percent of for-profit private companies reported the same (Smartpros, 2005). States, especially ones that have experienced notorious not-for-profit bankruptcies and other scandals, may pass legislation. Bond markets and state attorneys general may require similar governance provisions. Assessment of governance and management is an important component of Moody's rating methodology for higher education and nonprofits ("Moody's Approach …," 2004). Insurers may penalize entities that don't comply with SOX.

Managements and boards may institute some of the SOX reforms as a type of best-practice standards. The SOX provisions likely to migrate to nonprofits include enhanced role of the audit committee, certification of financial statements, compensation of senior executives, CFO code of conduct, and enhanced enforcement powers to remove unfit directors (O'Hare, 2002). Thirty-six percent of nonprofits have changed governance structure and policies in response to SOX. Eight percent have had significant changes. Another 35% said that they anticipate making other adjustments in the future, led by adding or changing whistle-blower policies, changing audit committee rules and hiring outside advisers (Epstein, 2004).

A 2004 survey of nonprofits conducted by Grant Thornton had 700 respondents. Eighty percent of survey respondents were familiar with SOX, as compared to 56% in 2003. Half of the respondents indicated that they have implemented some SOX policies. Seventy-six percent have a conflict of interest policy. Fifty-six percent have organization-wide policies/procedures relating to internal controls; 54% have a code of ethics; 54% have an audit committee charter; 45% have new board policies; 43% have a records retention policy; 29% have a whistleblower policy (The 2004 Grant …, 2004).

CONCLUSION

The Sarbanes-Oxley act was legislated in response to corporate frauds. The public trust was undermined by publicly-held companies that attracted investor dollars through fictitious financial statements and unethical behavior. Although not initially intended to apply to non-public or non-profit organizations, the Act has impacted those entities. The impact of SOX on public companies has generated a great deal of interest and will continue to be studied by investors, corporations and researchers. The impact of SOX on private companies and not-for-profit organizations is also of interest, but has not received as much attention.

This paper addresses some issues regarding the impact of SOX on non-public entities. Private companies may be reconsidering their plans to go public. Public companies may be planning to go private in order to avoid some of the SOX requirements. Private companies and non-profit organizations are rethinking their internal control systems, focusing on risk management, and reviewing their financial reporting responsibilities. Although not directly targeting non-public entities, SOX is clearly having an effect on those entities.

Additional research is needed to study the impact of SOX on private companies and non-profit organizations as well as the likelihood of legislation in the future that is targeted for those concerns. The investing, business, philanthropic, and academic communities are interested in existing and future regulation of non-public companies. Will more public companies go private? Will angel investors and venture capitalists want more assurances before investing in a private company? Will donors insist on SOX-like requirements, demanding more controls and systems from charitable organizations? Will university boards of trustees want more involvement by internal and external auditors? These questions represent a sample of questions to be addressed in future studies.

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