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WHITE PAPER:
Sarbanes-Oxley

Sarbanes-Oxley and You: How Sarbanes-Oxley Will Affect Private Companies

The enactment of the Sarbanes-Oxley Act in July of 2002 is effecting far-reaching changes in corporate governance, financial statement disclosure, management compensation and auditor independence. For the most part, these reforms are applicable to public companies only. However, many private companies will be significantly affected by the indirect and long-term effects of these reforms. As a result, there are a significant number of private companies that are adopting appropriate Sarbanes-Oxley type corporate governances. For instance, public and private companies alike are adopting the so-called whistleblower provision under the law.

> *"We're trying to stay in lock-step with them, even though we are not statutorily required to comply under Sarbanes-Oxley, it's just good business." Tom Wheeler, President, Information Intellect, Inc.*

Why should private companies bother? Several factors support the implementation of corporate governance reforms that mirror those required by private companies: Insistence by third parties, such as key business partners and investors, State requirements, litigation avoidance, preparation for going public and simply adding value to the organization.

> *"If you are not Sarbanes-Oxley compliant, you have got a lot of catching up to do."*
> *Brooke Seawell, Technology Crossover Ventures*

What You Need to Implement Now
In a survey of 1,400 chief financial officers at private companies published in the Journal of Accountancy, 44% said they are either reviewing or changing the accounting procedures within their organization as a result of Sarbanes-Oxley. In addition, privately held agribusiness has already taken steps to address the mandates of Sarbanes-Oxley because it has government contracts that require compliance.

The following outlines the provisions of the Sarbanes-Oxley Act that currently apply to private companies:

- Liability for Retaliation Against Whistle-Blowers. Fines and imprisonment of up to 10 years for knowingly retaliating against any person, including interfering with employment of the person, for providing law enforcement any truthful information relating to any federal offense.

- Criminal Liability for Document Destruction. Fine and/or imprisonment of up to 20 years for knowingly altering, destroying, concealing or falsifying any record, document, or tangible object with intent to impede, obstruct or influence the investigation or administration of any matter within the jurisdiction of any department or agency of the United States of any bankruptcy case under Title 11 of the United States Code. Private companies should either update their document retention policies or adopt policies in compliance with SOA guidelines now.

- Increased Penalties for Securities Fraud. The statute of limitations for federal securities fraud litigation has been extended to five years. In addition, debts incurred in violation of federal or state securities laws (or any common law fraud) are non-dischargeable in bankruptcy.

- Increased Liability for White Collar Crimes. Any attempt to commit or conspiracy to commit, any offense under white-collar crime or consumer protection laws is now punishable to the same extent as the underlying crime. Penalties for mail and wire fraud increased from 5 to 20 years. Penalties for certain ERISA violations are increased as well.

- Notice of Defined Benefit Plan Blackout Periods. Plan administrators must notify participants in writing at least 30 days in advance of any black-out period under the plan. A black-out period is any period exceeding three consecutive days when plan participants are precluded from directing their account assets.

What You Should Consider Adopting
The following outlines the provisions of the Sarbanes-Oxley Act that private companies may wish to voluntarily adopt:

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- Restrictions on Loans to Executive Officers and Directors. All public companies are prohibited from extending or maintaining credit in the form of a personal loan to any executive officer or director. Find ways to compensate executives that do not involve extending credit. In situations where loans are already in place, it is critical to have a mechanism to extinguish those loans prior to filing a registration statement under the 1933 Act.

- Board of Director Independence. Major stock exchanges require at least a majority of independent directors on the board of public companies listed on those exchanges. Any private company considering going public will need to assemble a board with a majority of independent directors. Private companies should also review their board composition to ensure that there is sufficient independent participation to allow the board to be viewed with integrity.

- Independent Audit Committees. Public companies are required to have an independent audit committee, with increasingly stringent requirements for independence. Private companies should consider establishing audit committees consisting solely of independent directors. NASDAQ has proposed a rule that a director would not be independent for purposes of serving on the audit committee if he owns or controls 20% or more of the company's stock. Visitation rights, rather than or in addition to board participation should be included in venture capital financing agreements.

- Audit Committee Charter. An audit committee should have a written charter that specifies its role and responsibilities. Private companies should consider documenting what functions are delegated to the audit committee and what rights the committee possesses. In the absence of an audit committee, private company boards are advised to have a corporate compliance plan for the entire board that includes many of the provisions typically included in an audit committee charter.

Recommended Best Practices for Early Adoption
The Act also contains provisions that may eventually become "best practices" that private companies should adopt or emulate to be perceived as having established a foundation for ethical corporate government.

The following outlines the provisions of the Sarbanes-Oxley Act that may Become "Best Practices":

- **Code of Ethics.** The Act requires that public companies disclose whether they have adopted codes of corporate ethics, with the intent to make such codes accepted practice in corporate America. A corporation's defense to civil or criminal litigation is likely to be strengthened by the presence of a strong code of ethics that is diligently enforced. If these codes become commonplace, they should not be ignored.

- **Relationships with Auditors.** Historically, company auditors have provided a variety of non-audit services to their clients. The Act prohibits auditors of public companies from providing several types of non-audit services (e.g. bookkeeping, financial information system design, appraisal, valuation, legal services, etc.) for their clients, and requires other services to be pre-approved by the audit committee. Private companies should review the types of non-audit services being provided by their auditors and consider whether it might be more appropriate for those services to be provided by a third party in order to avoid any appearance of impropriety.

- **Other Board Committees.** Exchange listing rules are requiring public companies to have separate committees on their boards, such as nominating, corporate governance and compensation committees. Private companies, especially those with larger boards, should consider creating a separate committee, composed of more independent members, to perform those and other similar functions. Alternatively, they may wish to adopt board policies wherein certain types of decisions can only be made by the independent members of the board.

Additional Recommendations
Given that the financial information system of an organization, public or private, is so intricately entwined with the operation of the organization, the following outlines recommended steps to take with regard to updating financial information systems to encourage and enforce Sarbanes-Oxley type governances:

1. Adopt a single source of information for both financial and non-financial data. Organizations need a single system to provide a way to look both ahead and behind as they develop and grow.

2. Make that system Web-based with broad access. Information should not be hidden in the accounting department, away from the rest of the company.

3. Implement real-time reporting capabilities. Companies can no longer wait for a three-month cycle. The information needs to be visible immediately.

4. Implement systems software that communicate objectives and match key performance indicators from all sides of the company to identify areas that will affect value.

5. Provide flexible projections. Organizations need to have historical and predictive data in one place in order to model the effects of possible scenarios or events that could affect the company.

6. Establish an environment that promotes collaboration and a continuous flow of information. Everyone needs to be involved in collecting, reporting, cleansing and signing off on the data.

7. Implement a system that will provide international awareness to the organization. A system with language support and functionality that addresses the complex reporting requirements of the European Union will be able to tightly integrate and streamline the processing of data.

While the Sarbanes-Oxley Act is principally directed at publicly-traded companies, it provides useful guidelines for good corporate practices that are equally applicable to many private companies. We recommend that private companies consider undertaking a Sarbanes-Oxley audit to consider which of the Act's provision might be appropriate for their consideration, including their financial information systems.

Implementing the foregoing steps and complying with Sarbanes-Oxley demands that the CIO and CFO work together, as they will be the ones exposed should any problems arise. However, the CIO will be the one that is looked to for documentation on the entire company, including software. Sarbanes-Oxley requires more than one single vendor can supply. Having a system, corporate procedures, and a single data source are the three most critical elements in establishing compliance.

> *"Private companies should implement the same type of governance and control practices required by Sarbanes- Oxley. The stage is set for private companies to significantly expand their corporate governance and financial reporting requirements.'" John Covaleski, Accounting Today*

It's time to take stock of your systems and procedures before it's too late. Be part of the cutting edge. Taking proactive measures to comply with Sarbanes-Oxley will give you the advantage your company needs if and when these measures become a requirement for private companies. Implementing a superior business and financial management system that can house all of your data is one of the best places to start. What's more, it will alleviate the stress and pressure placed on you and your managers by providing the one thing you need most: control.

For more information about Sarbanes-Oxley:

www.findlaw.com
Download the complete Sarbanes-Oxley Act

www.protiviti.com
Download "Insights on Today's Sarbanes-Oxley and Corporate Governance Challenges" A survey of chief financial officers with 300 publicly held U.S. companies

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White Paper Contact:
Marketing@accountmate.com

AccountMate Software Corporation
1445 Technology Lane | Suite A3 | Petaluma, California 94954 | USA
800-877-8896 | 707-774-7500 | www.accountmate.com

AM7960_5903