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Public or Non-Public . . . Sarbanes-Oxley Spurs Compliance

Dear Friends:

Thirteen years ago, in the wake of several corporate scandals, Congress passed the American Competitiveness and Corporate Accountability Act, more commonly known as Sarbanes-Oxley. The Act has been far-reaching, its regulatory tentacles extending beyond the public companies it targeted into the operations of private companies. In this issue's feature, we explore the why and how of non-public compliance, as well as some important takeaways for media operating in this regulatory climate.

Our fall calendar of events includes the 2015 BCCA Media Credit Seminar, October 8 in New York, New York, where we are pleased to be a lunch sponsor; and the Szabo Holiday Party, December 12 in Atlanta.

Best wishes for a fine fall season,

Robin Szabo, President
Szabo Associates, Inc.

Call it a shining example of unintended consequences. Or perhaps an embrace of measures newly-recognized as good corporate governance. In any case, the American Competitiveness and Corporate Accountability Act of 2002—more commonly and succinctly known as Sarbanes-Oxley (SOX)—has worked its way into the everyday business operations of many private companies in addition to the public companies it targeted.

We all remember these troubling news items of 2001 and 2002: " 'Off the books' debt by a leading American company leads to bankruptcy and loss of jobs and retirement savings to thousands of employees." " 'Creative' accounting practices lead to the decline of a major accounting company." "CFOs join CEOs on the hot seat." "President Bush admonishes businesses to 'come clean or else.' "

In order to rebuild public trust in the corporate sector in the wake of these scandals, Congress passed SOX with overwhelming bipartisan political support. Prior to SOX, federal and state laws did not establish specific standards that corporations were required to meet with regard to information released to the public in financial reports. As a result, the only recourse for defrauded investors was to try to persuade the court, without the benefits of standards, that they were damaged by inaccurate or untruthful financial information.

SOX required publicly traded companies to adhere to significant new governance standards. The new law added criminal penalties and prison terms for corporate fraud and document shredding; imposed restrictions on accounting firms that do consulting work for corporations whose books they audit; required top company executives to vouch personally for the accuracy of their companies' reports; imposed new rules for financial analysts designed to prevent conflicts of interest; and established the Public Company Accounting Oversight Board (PCAOB), a private-sector nonprofit corporation—with power to subpoena—to oversee auditors of public companies.

Implications for Private Companies.

Why, in a world of increased regulatory complexity, would a company opt to comply with a law that does not apply to it? Compliance almost always translates into increased cost, so would those dollars not be better spent in other ways?

Exceptions to the Exemptions. A couple of SOX's provisions apply to all organizations, whether publicly traded or not. The Whistleblower Protection Policy requires all organizations to establish a method to collect, retain, and resolve claims with regard to accounting, internal accounting controls, and auditing issues. The system must allow the anonymous submission of such concerns, and the Act imposes severe penalties on those who retaliate

—continued on page 2

Sarbanes-Oxley—

—continued from page 1

against whistleblowers.

The Document Retention Policy imposes new requirements with regard to destruction of documents and retention of audit and review records. The former creates new criminal penalties (either a fine or imprisonment up to 20 years) for document alteration or destruction with the intent to obstruct an investigation or other matters within the jurisdiction of a federal agency or bankruptcy court. The latter, directed at auditors, creates a new felony that applies to willful failure to preserve audit or review records of issuers.

SOX broadly defines "records" to include any material, including email, that contains information about the company's plan, results, policies, or performance. Email must be tamper-proof, password-protected, read-only, non-deletable, encrypted, digitally signed, and auditable by a third party. Depending on the document, retention is required for several years to forever. Company management and the IT department have the responsibility for creating a policy and processes for compliance. Any employee aware that the company is under investigation, or suspects that it might be, must stop all document destruction and alteration immediately. The employee must also create a company record indicating the order to stop all automatic e-data destruction.

A new benchmark. With the passage of SOX, businesses now had a new standard against which their financial reporting and corporate governance practices could be measured, whether or not their compliance was legally required. Understandably, companies that are considering going public or may be acquired by a public company are particularly compelled to become SOX-compliant; however, such companies represent a small percentage of SOX-compliant private companies. Private companies with large outside shareholder bases or institutional investors, while not technically public, have shareholders who may expect or demand the standard of corporate governance prescribed by the law. Additionally, venture capital investors, lenders, and insurers doing business with non-public companies may now require covenants related to corporate governance in financing agreements.

Numerous surveys have been conducted to find out if and why private companies choose to comply with the Act. According to a 2006 survey by Reed, Buchman, and Wobbekind, and noted in a report by Strehlow, Flasch, Vandenberg, and Haen of St. Norbert College, more than 50% of respondents indicated several possible benefits: establishing stronger business credit, potentially getting better major financing options, and enhancing credibility with key stakeholders. High costs with no specific benefits were reasons specific provisions were not implemented. Another 2006 study by Foley and Lardner reported that pressure from outside auditors and/or board members were additional reasons for compliance, and that low-cost provisions were those most likely to be implemented.

The researchers at St. Norbert conducted phone interviews of four privately-held companies to gain more in-depth insight. The companies ranged in size from $500 million to $3.5 billion and represented four distinct industries. The authors concluded that there was a newly-heightened focus on internal controls and corporate governance, both by the companies and their external auditors. Of note is that the companies, recognizing certain measures as good corporate governance, had implemented many of SOX's provisions well before the law's passage.

And the takeaway from all this? Many non-public companies are choosing, from the buffet of voluntary SOX provisions, those that benefit their organizations and that come with a reasonable price tag to implement and maintain.

A code of ethics is generally recognized as a good idea, as it establishes an atmosphere of propriety at the top and helps employees understand what is expected of them. Should a corporation be faced with civil or criminal allegations, the presence of a strong code of ethics may strengthen its defense. Additionally, some companies have implemented whistleblower procedures, formal channels an employee can use to report ethical concerns within the company. Others, feeling confident that their companies already support the reporting of ethical concerns, choose to have no formal program.

Since internal controls are now more of a consideration for external auditors, companies are focusing on internal control structures, and more employees are becoming involved in the audit process. Some external auditors, particularly those with a strong public presence, now require the CEOs/CFOs of non-public companies to attest to the accuracy of their financial statements. Many private companies are creating audit committees composed of outside directors or naming an audit committee "financial expert." Such committees provide auditors a conduit to the board outside of management as well as a financial expert who can lead discussions with auditors about transactions and the handling of accounts in financial statements.

These processes can reap financial benefits that offset, at least in part, the financial investment for implementation. For example, according to the 2006 Report to the Nation by the Association of Certified Fraud Examiners, U.S. organizations lose five percent of their annual revenues to fraud. The report also stated that "occupational frauds are more likely to be detected by a tip than by other means such as internal audits, external audits, or internal controls." Establishing an environment where employees feel they are safe to expose misbehavior can potentially increase a company's profits. Additionally, a strong code of ethics may help prevent litigation or at least reduce its costs.

Requiring the CEO and CFO to certify the accuracy of financial statements increases public confidence about the financial

condition and operations of the company. This responsibility brings about increased focus on control deficiencies, which enables an organization to determine "what can go wrong" in preparing financial information and to take measures to prevent it from happening. Auditing firms faced with increased responsibilities are more apt to work more closely with their clients, resulting in a better understanding of their operations and, subsequently, more valuable input to improve internal controls. Private companies are not compelled to spend inordinate sums of money to prepare for an auditor's assessment of internal controls or to implement a complex system of controls to achieve compliance with the Act. Rather, they can apply a reasonable cost/benefit approach, choosing the provisions and controls that benefit their organizations with an acceptable price tag.

Implications for Credit Managers.

One significant result of SOX is the close scrutiny being given to credit departments. Section 404 of the Act aims to ensure proper representation of assets, requiring receivables to be accurately qualified and quantified. SOX standards offer the opportunity to study, scrub, and improve credit procedures at both the macro and micro levels.

While company officers are making fervent efforts to ensure that their financial statement numbers are accurate and truly represent their companies' financial health, they also want those numbers to be attractive to long-term investors. For many, that means they must reduce their debt. Receivables that have aged to the point of little or no chance of collection will attract a higher degree of scrutiny by controllers and division heads mandated to present a true financial picture and, at the same time, to make that picture attractive.

Tips for the Times.

The scandals of 15 years ago and the subsequent passage of Sarbanes-Oxley have ushered in new standards of behavior in corporate America. Within this climate of higher expectations, almost all organizations can benefit from some stronger internal controls and SOX best practices, whether mandated or not. Here are some areas to consider for review and analysis:

1. Credit policy. Is it applied across all departments and locations? Is your decision-making process reasonable, justifiable, and consistent? Do you regularly review accounts and reevaluate credit lines to reflect the condition of your current portfolio?

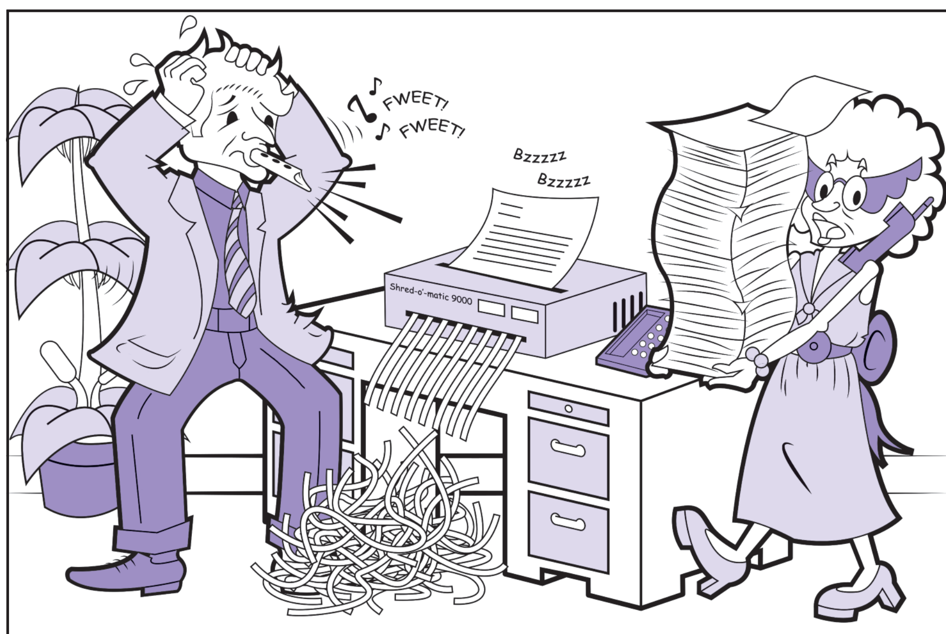
2. Collection procedures. If staff has made its best efforts beginning at 15 days past due to collect, and the account has broken a number of commitments, has a deteriorating financial condition, or has aged to 90 days, third-party collection action is in order. At 120 days, it should immediately be turned over for collection, unless there are unresolved discrepancies, whether or not it has been written off. The goal is to collect—not to write off—and a professional industry-knowledgeable collection firm that is adept with both slow-pay and no-pay customers is the right choice when you wish to recover and keep your customer.

3. Write-off procedures. Szabo has observed that the process for determining write-offs has changed with some clients. Historically, write-offs occurred following a customer's bankruptcy or after a write-off recommendation from a third-party collector. Recently, however, the trend is to write off solely on age of delinquency, in many instances at or beyond 180 days age, then engage a third-party collector. Write-offs should not be solely based on age and should not be a prerequisite to engaging a third-party collector. Each action should be independent.

With new emphasis on accuracy and transparency, companies often feel pressure to ensure that their receivables are not stated above the amounts they can reasonably expect to recover. In the SOX environment, credit managers may feel compelled to write off an account that it deems uncollectible as a matter of prudence. Unfortunately, as we all know, the debit entry cancels out the profit of the sale previously recorded in the income statement, undermining the attractiveness of the company's financial picture.

Premature write-offs can best

—continued on page 4



"Boss, I think it's time to hold a learning seminar on the 'whistleblower protection' and 'document retention' rules of Sarbanes-Oxley."

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Sarbanes-Oxley—

—continued from page 3

be avoided with strong credit policy and consistently applied collection procedures. While bankruptcies may not always be anticipated, monitoring of accounts and industries can make those in prospective trouble come to light sooner. Proper procedures, involving prioritization of accounts, timely efforts to collect, and turnover of accounts to a third-party collector before they truly become uncollectible can substantially reduce write-offs and improve your bottom line.

4. Whistleblower protection. Does your environment allow employees to report unethical behavior without fear of consequences? Does your company have a formal code of ethics? If not, might it be beneficial?

5. Document retention. Does your company have a policy of retaining every type of file created by company employees, including internal memos, emails, and instant messaging? Has your IT department created solutions for the secure storage, maintenance, and management of the data? Is email fully accessible and searchable for audit by a third party?

6. Internal processes with regard to auditing. Does your auditor require your CEO and CFO to certify the accuracy of financial statements? Do you or should you have an audit committee? Does it include a "financial expert" among its members?

7. Voluntary provisions of the law. Non-public companies are in the enviable position of being able to choose those SOX provisions they find valuable and also the extent to which they want to go with implementation. Analyze SOX to determine which of its requirements might be useful to your organization to adopt, and conduct an analysis to determine their relative costs and benefits. Engage your CPA for advice regarding which sections of the Act might be best for your organization and how you can best implement them.

Many of the principles behind Sarbanes-Oxley are sound and should resonate with all organizations, whether public or private. Whether or not your organization is required to comply, understanding the principles and subsequent requirements of SOX can help improve your controls and processes, resulting in improved DSO and greater profits. ♦