Managing Theory & Practice: Sarbanes-Oxley Gains Adherents --- Closely Held Companies Embrace Internal Controls As Incentives, Pressure Rise

By Jaclyne Badal and Phred Dvorak

EXPENSIVE, ONEROUS and unnecessary -- those are a few of the complaints U.S. publicly traded companies have leveled at the Sarbanes-Oxley Act, designed to keep companies honest. Yet auditors say an increasing number of closely held companies are complying with parts of the corporate-reform law -- even though they don't have to. Some of these private-sector companies have investors who hope the company will one day go public, or will be acquired. Others think adhering to the law's requirements will make their businesses more efficient. Still others face pressure from lenders or customers, including government agencies, who value the strong internal controls required by Sarbanes-Oxley.

Printing-press manufacturer Goss International Corp.'s chief financial officer, Joe Gaynor, began to look into Sarbanes-Oxley last year, because he thought the $1.1 billion Bolingbrook, Ill., company could benefit from standardizing its policies and procedures. Goss's eight business units operated independently, with varying rules. Mr. Gaynor worried about gaps in human-resource policies, such as making sure employees were paid only for hours they worked.

Then Goss's primary shareholder, investment-management firm MatlinPatterson Global Advisers LLC, of New York, weighed in. Another company in MatlinPatterson's portfolio had just gone public, forcing a scramble to comply with Sarbanes-Oxley.

Mr. Gaynor says Goss has no immediate plans to go public, but MatlinPatterson pushed Goss's board to comply with the law's provisions for internal controls that are designed to prevent fraud and reduce financial-reporting errors.

An internal control helps companies follow their own policies. It can be as simple as requiring a purchase order number to buy a big-ticket item, to document that an expense was properly approved. Or it can be a detailed process to track inventory.

Mr. Gaynor says Goss is reviewing its internal controls. It upgraded its technology department, ensuring that both the computers and software were reliable and had backups. It strengthened the board's audit committee and made its meetings more regular. At the end of 2007, Mr. Gaynor plans to hire PricewaterhouseCoopers for a "dry-run" audit to identify potential weaknesses.

Other companies want to show they have strong internal controls because they handle U.S. government contracts and may be audited, says James Mattie, national-assurance leader for PricewaterhouseCoopers Private Company Services, which the New York accounting company started in July. One client, a company that provides consulting services to the government, found that a government agency it did business with wanted to check its billing controls to ensure it wasn't charging too much.

In other cases, companies feel pressure from publicly traded customers or suppliers, who must demonstrate that their controls meet the Sarbanes-Oxley standards. "The stakes have gotten higher in public companies," Mr. Mattie says. "Some of that extends to the network of suppliers."

Mr. Mattie says few private-company clients comply with all parts of Sarbanes-Oxley -- particularly the expensive rule that controls be cross-checked by an independent auditor. But about one-quarter of his private clients are taking steps to comply with some parts of the law. Others want advice about what parts of Sarbanes-Oxley might be appropriate for them to follow.

Ryan LaFond, an assistant professor at MIT Sloan School of Management in Cambridge, Mass., says there may be a financial incentive for private companies to comply with the law -- internal controls can help them raise money at lower cost.

Mr. LaFond tracked 221 publicly traded companies that had admitted to weaknesses with their internal controls. When a third-party auditor certified that the company had fixed its problems and strengthened controls, companies could raise money more cheaply.

The same dynamic can work for closely held companies. Wells Fargo & Co. routinely asks potential borrowers about their internal controls and corporate-governance practices, says chief credit officer Mike Loughlin. The San Francisco bank doesn't require companies to comply with Sarbanes-Oxley, but the controls are a factor in whether a loan is approved.

One company that has felt the pressure to comply with Sarbanes-Oxley is Financial Engines Inc., a Palo Alto, Calif., investment adviser and portfolio manager, with $5 billion under management. Lenders commonly want to be able to audit the company's controls, especially those relating to money due the firm, says Ray Sims, the chief financial officer. And institutional clients want to make sure the information-technology systems are up to snuff.

Mr. Sims says Financial Engines employs controls similar to those required by Sarbanes-Oxley, but stops short of hiring an outside auditor to run a secondary test. Sarbanes-Oxley rules are also used as a guide for the board. The Financial Engines board has an audit committee and a compensation committee, both headed by independent directors, as the law requires.