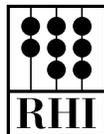


# The Impact of Sarbanes-Oxley on Private Business

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Are the New Rules Giving Rise to a Universal Standard?



**Robert Half International Inc.**

*Worldwide Leader in Specialized Staffing Services Since 1948*

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# Executive Summary

Although the Sarbanes-Oxley Act of 2002 (SOA) focuses on public companies, many private firms are adopting its provisions to ensure their own practices are consistent with what is becoming the new standard for business conduct. The most progressive privately held companies view today's accounting reform environment as a significant opportunity to improve internal control and governance processes in their organizations.

Firms that respond by adopting some degree of voluntary compliance can better position themselves for establishing strong business credit and obtaining major financing. In addition, they are able to enhance relationships and credibility with key stakeholders, since a variety of constituencies increasingly expect firms to uphold a solid reputation for openness and integrity.

All private companies and nonprofit organizations should investigate how SOA — and its repercussions — may affect their operations. Private entities may encounter third-party pressures to comply from a variety of stakeholders. Organizations most likely to be affected by the legislation include those that rely heavily on lenders or insurers, do business with government entities, report to federal regulatory agencies, are planning to go public, or consider themselves acquisition targets.

Many private companies are finding that the most prudent approach is to voluntarily adopt key reform standards appropriate for their business. Some are already taking such steps as establishing an internal audit function, inducting independent board members, limiting or separating services provided by their external accounting firm to avoid potential conflicts of interest, adopting a formal code of ethics, providing formal certifications of financial information and enhancing accounting competencies.

Some consider the prospect of future copycat laws and state mandates likely, but, in the meantime, many business leaders will opt to willingly comply with SOA simply because it makes good business sense. Even if SOA never affects private companies directly, they must acknowledge that it is now the corporate world's template for effective accounting and governance practices.

# Introduction

*Although the corporate scandals that gave rise to accounting reforms involved public companies, the knowledge gained in the aftermath of those events is widely instructive.*

Sarbanes-Oxley is already having a profound impact on corporate governance practices. Although the legislation is aimed at public companies, private firms are by no means immune to the need for improved governance and internal control processes. Private entities should consider taking a cue from what is happening at public firms and make sure their own practices are sound and reflect a strong focus on financial disclosure and integrity.

Many forward-looking private companies are already taking action. They accept SOA as the new standard for business conduct and see advantages in adopting its key provisions. “We have heard from many private organizations that confirm this trend,” says Bill Bishop, president of The Institute of Internal Auditors (The IIA). “They tell us they intend to comply, whether required or not, because it is just good business.”

Private entities should consider how SOA may affect their operations. Seemingly overnight, it has become the benchmark against which every company’s financial reporting and disclosure and corporate governance practices are measured. In addition to willingly adopting what are essentially best practices in corporate governance, private firms may encounter various external pushes to comply with the spirit of SOA. These marketplace expectations suggest that private companies should also adhere to the prevailing standards as well as new mandates if states and accounting boards pass parallel laws and regulations.

Many private organizations are understandably concerned about what the law could mean for them. After all, a key reason they remain private is to operate with minimal regulatory intrusion and without the need to answer to public shareholders. Some private firms also consider the new standards impractical or unnecessary for them, since reforms were designed to address public company issues. Concerns exist, too, about the cost and time commitments involved if reforms are pushed down to the private sector.

Private organizations trying to assess and possibly apply Sarbanes-Oxley may find that there are more questions than answers. However, as reforms wind their way through both the public and private sectors, expectations for private company conduct will inevitably become more clear. In the meantime, the most progressive private companies are being proactive in understanding how regulations are impacting public companies and taking steps to ensure their own practices are solid.

# Lessons Learned

Although the corporate scandals that gave rise to accounting reforms involved public companies, the knowledge gained in the aftermath of those events is widely instructive. All companies can apply this knowledge to identify improvement opportunities in their own organizations.

Sarbanes-Oxley is wide-ranging in scope. It calls for extensive changes in financial reporting and disclosure systems, and places restrictions on how public companies and their auditors operate. The most influential provisions reflect a cohesive approach to addressing the underlying problems that led to the scandals. Those events underscored fundamental principles of ethical corporate conduct, including:

- Financial statements must fairly present the condition of the business. (Sec. 401)
- Chief executives must take personal responsibility for the accuracy and completeness of corporate financial statements. (Sec. 302)
- Non-audit services by external auditors should be restricted to prevent real or perceived conflicts of interest that cast doubt on audit integrity. (Secs. 201, 202 and 206)
- Companies need independent, knowledgeable boards and audit committees that will uphold shareholder interests by challenging management and auditors on important issues. (Secs. 301 and 305)
- A strong system of internal controls is necessary to stem fraud and abuse. (Sec. 404)
- Companies must articulate and demonstrate an ethical culture from the top down. (Sec. 406)

*“[SOA] sets the standard for what a disclosure should be like, what internal controls should be in place and what kind of independence should be followed — all those pieces are going to become the standard whether you’re private or public.”*

**Lawrence Lake,  
Managing Director,  
Protiviti Inc.**

These principles have been incorporated into key SOA provisions — most notably, sections 202, 302 and 404. Section 202 pertains to audit committee preapproval of audit and permissible non-audit services; Section 302 requires executive certification as to the effectiveness of disclosure controls and procedures; and Section 404 — for which the Securities and Exchange Commission (SEC) recently issued its final rules — requires management to file an internal control report with the annual report. These landmark provisions, in addition to similar ones enacted by the stock exchanges, have the most potential to influence the operations of not only public but also private companies.

Many business and legal observers have said it is likely that third-party pressures from various stakeholders — including industry regulators, lenders, insurers, government entities and accountants — could lead to a form of de facto compliance by private companies with many of Sarbanes-Oxley’s key standards. In addition, more than a dozen states have adopted or proposed some form of parallel legislation aimed at public and private companies or their auditors that could result in some degree of mandated compliance. For example, California has passed several laws that address issues such as retention of audit papers and prohibitions on auditors joining client companies. These related actions are sometimes referred to as the Sarbanes-Oxley “cascade.”

# Who Could be Affected

For purposes of this discussion, private companies are defined broadly as: large, privately held companies; small, private companies that may be closely held, including family businesses; and private nonprofit organizations.

The International Federation of Accountants uses the term “public interest entities” for organizations in the latter category. Because of their size, status, nature of their business or range of stakeholders, these organizations have significant public responsibility. Examples in this category include colleges and universities, charitable organizations, hospitals, religious institutions, labor unions and professional or trade associations. These public interest entities may have the greatest likelihood of being held to the new, higher standards for corporate governance and financial reporting.

Sarbanes-Oxley is now the corporate world’s template for effective accounting and governance practices. “It sets the standard for what a disclosure should be like, what internal controls should be in place and what kind of independence should be followed — all those pieces are going to become the standard whether you’re private or public,” says Lawrence Lake, a managing director with Protiviti Inc., a leading internal audit and risk consulting firm and a wholly owned subsidiary of Robert Half International Inc.

Private companies with one or more of the following characteristics could be affected by recent accounting reforms:

- Those with heavy reliance on lenders or insurers could encounter additional questions about financial disclosure or governance practices as a condition of accessing capital or renewing insurance premiums. Many anticipate that lenders and insurers might ask for more detailed financial information or additional explanation similar to the “management’s discussion and analysis (MD&A)” section that accompanies public statements, some form of executive certification, more extensive audits or audits by a different firm than traditionally used.

- Private companies that do business with government entities will likely have to meet certain aspects of the new standards. This is already occurring at the state level. In Indiana, the state amended its request for proposal (RFP) to add language that requires public and private company vendors to provide information consistent with Sarbanes-Oxley. For instance, a chief executive must attest to the thoroughness and correctness of accompanying financial information. Proposals must also include information about a company's board and audit committee, separation of audit and non-audit services, and the manner in which the company ensures board integrity. According to the state, although Sarbanes-Oxley is not directly applicable to the proposal process, the Act's goals were used to develop requirements for mandatory information.
- Businesses that report to federal regulatory agencies may be expected to comply to some degree with accounting reforms. Several agencies are said to be considering more stringent standards, and the Federal Deposit Insurance Corporation (FDIC) has already issued guidance to the banking industry encouraging it to adopt key reform standards.

The FDIC encourages even small banks with assets under \$500 million, the SEC reporting threshold, to adopt accounting and governance processes in line with reforms. Specifically, the FDIC suggests that banks use separate firms for external and internal audit functions, adopt an ethics code for officers, supplement the external audit with an internal control assessment that carries an outside accountant's attestation, and encourage interaction between audit committees and external auditors.

- Although most private organizations are not directly impacted by SOA, Section 404 states that unlisted companies with public debt must comply with the SEC's reporting requirements, including the executive certification and internal control reporting requirements, in the fiscal year the registration statements for such debt are declared effective. Companies with large numbers of outside shareholders or private equity investors could be held to additional disclosure and control standards if they become

*To increase their protection, public companies could pressure their private partners to improve their internal controls or governance processes as a condition of working together, especially if a private company partner receives favorable credit terms or long-term contracts.*

subject to legal or regulatory action. For instance, as part of its settlement with the SEC, a retail cooperative agreed to take certain actions consistent with accounting reforms, including: employing an internal audit director, hiring a public accounting firm to assist in internal auditing, and filing annual reports on its audits and internal controls with the SEC. Although not publicly traded, the cooperative falls under SEC reporting requirements because it has thousands of shareholders who operate independent stores.

- Private entities, particularly nonprofits, may be pressured by their board members to align with reforms. As board members with public-company backgrounds begin to view new regulations as standard operating procedure, it is likely they will expect the organizations they serve to uphold the same principles. “In many cases, these board members insist on compliance,” says The IIA’s Bishop. “Because they understand corporate governance, they are not willing to take the risks associated with shortcuts.” It is also anticipated that private companies, particularly nonprofits, that issue public bonds to raise capital will be expected to adopt reforms.
- Companies with corporate residency in states that enact parallel laws or regulations will be required to comply with provisions that stem from Sarbanes-Oxley. In some cases, proposed laws or professional regulations are aimed at all incorporated companies operating in a given state and at their certified public accountants (CPAs); in other instances, they apply solely to public companies and their auditors.

A recent tally by the American Institute of Certified Public Accountants (AICPA) showed that nearly 20 pieces of copycat legislation had been proposed in at least a dozen states, and new bills continue to be filed. In New York and California, in particular, aggressive legislation is pending that would extend reforms to private companies, nonprofit organizations and accountants.

- Even closely held private companies have numerous stakeholders, which may include public companies with which they do business. To increase their protection, public companies could pressure their private partners to improve their internal controls or governance processes as a condition of working together, especially if a private company partner receives favorable credit terms or long-term contracts. The possibility that public companies might seek additional assurances of this nature is consistent with the practice of companies asking partners and suppliers about their business continuity plans in an effort to protect against operational disruptions.
- Private firms with absentee owners may be asked to adopt certain reform provisions, particularly those relating to internal controls and executive certifications.
- Businesses that are considering going public should have a good grasp of what is required of public companies and take similar steps toward compliance, so they can meet requirements as soon as necessary. This includes planning for the costs of compliance — recruiting and compensating independent directors; acquiring director and officer liability insurance; and expanding staff, either on an in-house or outsourced basis. Companies that may be acquisition targets would also benefit from aligning with reforms because of the likelihood that public company suitors would have a higher comfort level with organizations that followed similar standards.
- Nonprofits could be the most likely of all private entities to be subject to reform standards. Because Sarbanes-Oxley doesn't address the issue of whether to extend regulations to these public interest entities, those questions are being raised elsewhere. In its Announcement 2002-87, the Internal Revenue Service (IRS) notes, "It may be argued that there are similarities between the need for veracity in the public information used by shareholders in making investment decisions and the need for veracity in the public information used by contributors and others in making decisions regarding exempt organizations."

*Private companies may find that the wisest approach – and certainly the most proactive one – is to voluntarily adopt key reform standards, rather than waiting for the standards to catch up to them.*

As a result, the IRS is considering changes to Form 990, the tax return for organizations exempt from income tax, to require additional governance and financial disclosures. Officers of nonprofits are already required to make certifications of financial integrity on other types of documents. Considering they might have to make additional disclosures in response to federal or state requirements, nonprofits would be wise to review their governance, risk assessment and financial reporting processes to determine their effectiveness.

- Both public and private organizations typically have a desire to adopt best practices used by leading companies. In terms of accounting processes and corporate governance, Sarbanes-Oxley embodies the current best practices, and some private firms will want to voluntarily adopt measures in line with it. These types of voluntary actions may have a ripple effect, compelling other businesses to take similar actions or face consternation from their stakeholders and peers. Public interest entities may feel a greater obligation to voluntarily comply.

One example of voluntary compliance is Drexel University in Philadelphia. The board of trustees amended its bylaws to incorporate key principles of SOA relating to audit committee independence, financial statement certification, protection of whistle-blowers and the audit committee's right to retain outside advisers. In announcing the actions, the board chairman noted, "We are not a public corporation, but we do the public's business." He added that the board's actions are intended to ensure that "the best practices used by business will be applied to this university."

With changes in accounting still sweeping across the business landscape, it is unclear to what degree reform will take hold in the larger marketplace and how this will affect private companies. But business and legal observers agree that private companies will undoubtedly experience some of the fallout. "Just because you're a private company, you're not off the hook," predicts Lake.

# How Private Companies are Responding

If the best defense is a good offense, private companies may find that the wisest approach — and certainly the most proactive one — is to voluntarily adopt key reform standards, rather than waiting for the standards to catch up to them. Some organizations have already responded in this way to the changed environment.

In a survey developed by Robert Half International, 58 percent of 1,400 chief financial officers (CFOs) from privately held businesses said their companies are responding to accounting regulations by implementing new practices. Among those who cited a specific action:

- 44% are reviewing or changing current accounting procedures
- 36% are creating or expanding the internal audit function
- 23% are hiring an independent firm for consulting work
- 8% are restructuring executive compensation plans
- 2% are taking some other action

Thirty-seven percent of CFOs indicated they are not taking any of the above steps, and 5 percent do not know what steps, if any, they will take. (Respondents were allowed to cite more than one action.)

In deciding how to respond to accounting reform, private entities should consider what's reasonable and practical for them. Some organizations will have more compelling reasons than others for making changes.

Nonetheless, many believe that the concepts addressed by new accounting regulations are ones that promote better management of any company, whether public or private. "Companies that say 'this doesn't pertain to me' are missing a pretty big opportunity to enact improvements for themselves," says Larry Rittenberg, Ernst & Young professor of accounting at the University of Wisconsin-Madison. He adds that while there are additional expenses associated with corporate governance and accounting reform compliance, "It always has benefits that outweigh the costs."

According to preliminary research by The IIA, the cost increases related to corporate reforms that private companies are seeing are mostly the same as those affecting the business community at large. They include: rising director and officer insurance; higher fees for external audits; increased costs related to internal audit expansion; and possible compensation increases for senior executives and board members. Private companies surveyed by The IIA note, however, that compliance issues are dominating their time, with some IIA members from private companies reporting that as much as 80 percent of management's time and attention has been devoted to compliance issues.

Companies that want to improve their accounting and governance procedures are already taking many of the steps below to enhance their corporate governance and internal control processes:

***Establishing an internal audit function.*** Internal auditors play an important role in evaluating the adequacy and effectiveness of an organization's internal controls. A company that lacks a strong control environment may be opening itself up to financial and operational risks.

A good option for smaller companies that may be interested in internal audit services but lack the personnel or skills to perform them is to establish the capabilities needed on a short-term basis by hiring a consultant or temporary professional. Effective internal control reviews can often be accomplished in fairly short time periods. Companies can benefit from a menu-like report that outlines the risks facing their organization, the magnitude of those risks and the cost of implementing proposed solutions, such as operational audits to address key areas. This approach allows companies to pick and choose whether and where they want to take further action, based on the significance of the risks and the costs of addressing them.

***Bringing in one or more independent board members.*** Independent board members provide objective oversight and can also become the foundation for an audit committee. An audit committee can help a company improve its focus on controls and financial management, which can be particularly useful for

companies that are preoccupied with operational issues. Furthermore, some legal experts believe audit committees will become essential for large private companies, and that there could be liability risks to companies that don't adopt them.

The use of independent directors and the formation of an audit committee are very productive governance practices, but a company has to be committed to these concepts to make them work. While closely held companies may be reluctant to bring in outside board members, to gain any benefit, owners and management must be receptive to the contributions these board members can make. Management should also compensate board members adequately and empower them to learn about the company.

***Separating professional services.*** Private companies seeking to align with reforms may want to consider limiting or separating the services provided by their external accounting firm to avoid potential conflicts of interest. Sarbanes-Oxley requires that companies use a firm other than the external auditor for certain consulting services, including internal auditing. Although private companies are not currently expected to meet this requirement, some also use CPAs for attestation and could show good faith by voluntarily separating audit services from other accounting or consulting services. Even private companies that perform a simple financial review in lieu of a full-fledged audit often have a relationship with an external CPA firm and may decide to similarly separate services. Already, some privately held firms are receiving increased scrutiny of their practices in this area. In Indiana, for example, private companies bidding on state contracts must disclose whether they have separated these services.

According to The IIA, one way some private companies are addressing this issue is by implementing what is known as a “pre-advise mandate,” which requires an audit committee to preapprove all non-audit work performed by an external auditor. This practice is a good example of how private companies can sensibly respond to the spirit of new reforms, even if it is not required or feasible to conform to the letter of the law.

***Adopting a formal code of ethics.*** An ethics code sets the bar for corporate conduct by officers. It can also enhance a company's stature in the eyes of stakeholders and may provide some legal protection if a company is sued. Companies can benefit by having a corporate culture that emphasizes ethics and integrity.

***Providing formal certifications of financial information.*** Some private companies have sent a message of greater accountability by implementing processes for certifying financial information and providing certifications along with financial statements to external parties. This practice is consistent with Sarbanes-Oxley, which requires executive officers to attest to the soundness of the control environment and to certify that financial statements fairly present a company's financial condition and results of operations.

Although not obligated by law to do so, Drexel University now requires its treasurer and CFO to provide certifications that include the same representations as those mandated by Sarbanes-Oxley. In addition, the university requires all unit heads to provide similar certifications when they issue monthly financial statements to the CFO or any financial information to external auditors.

***Enhancing accounting competencies.*** Private companies that implement new practices may need additional support to interpret and adapt new regulations. Rather than adding staff, many companies prefer bringing in outside expertise as needed on a short-term or project basis. Some private companies are responding to the new environment by lining up outsourcing partners so they can quickly address any risk- or reform-related needs that may arise.

Companies looking to add staff, whether full-time or temporary, would do well to find individuals who bring knowledge of both the financial and operational sides of auditing and a familiarity with regulatory issues. Adding these talents may be a worthwhile investment, considering the certainty that increased regulation is here to stay.

# Benefits to Private Business

Regardless of the extent to which new accounting and governance laws influence the private sector, private organizations will find themselves continually intersecting with new standards in the course of conducting business. Those that respond by adopting some degree of voluntary compliance can realize internal and external benefits that include:

***A stronger control environment.*** The accounting scandals that led to corporate reform underscored the need for better internal controls within companies. Strong controls tend to be more common in public firms because of the increased scrutiny and regulation they face, but all companies that strengthen the control environment reduce their exposure to potential risks.

Small, private companies may lack the personnel, technology or process sophistication to easily detect fraud, errors and other critical but unidentified risks. Often, irreversible damage has occurred by the time major control problems are uncovered. These companies, therefore, can reap some of the biggest benefits from enhancing the control environment. Among the practices that contribute to a strong control environment are internal control assessment and improvement, and the use of audit committees.

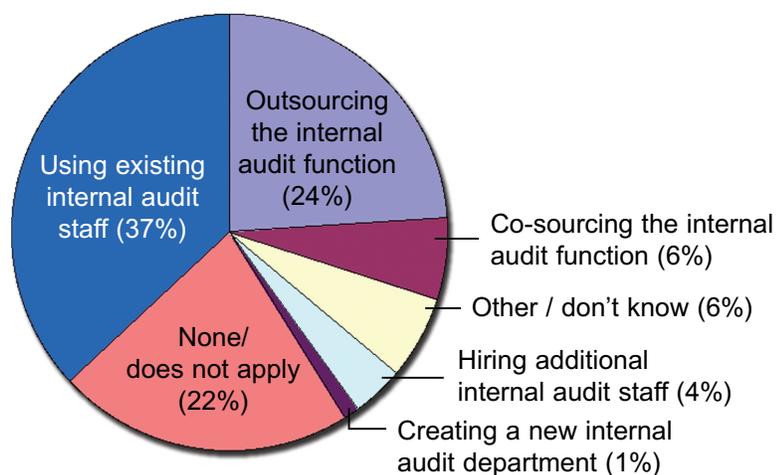
Large nonprofit organizations are also ideal candidates to realize significant benefits from improving the control environment. A loss of public trust stemming from poor financial management can greatly damage their reputation and subsequent fund-raising efforts.

***Enhanced relationships and credibility with key stakeholders.*** Part of being successful in business involves making customers, employees, lenders, insurers and other business partners feel good about a company and how it operates. Private businesses that adopt reform measures are likely to win increased confidence from internal and external stakeholders. In addition, these companies may have an advantage in establishing and maintaining strong relationships with public company business partners. Companies that voluntarily meet higher standards than necessary can also leverage their actions as a marketing tool to clients.

***Better positioning for establishing strong business credit and obtaining major financing.*** It's expected that some lenders may begin asking for information similar to that required by Sarbanes-Oxley. Private companies seeking a major capital infusion, particularly large companies, may receive requests of this nature. Business experts agree that the more a company can show it is well managed and well governed, the better positioned it is to secure capital. Some lenders may even equate qualities such as a strong system of internal controls with a high likelihood of business success.

## How Private Companies are Managing the Internal Audit Function

“In light of the Sarbanes-Oxley Act requirements for auditor independence and New York Stock Exchange rules mandating an internal audit function, how are you managing your company’s internal audit function, if at all?”



Source: Robert Half International survey of 1,400 CFOs from privately held U.S. companies

# The Mandate Question

Certainly, improving corporate governance makes business sense. But there is some debate over the issue of mandated controls. Many private organizations are quick to object to the prospect of government involvement. They argue that pushing regulations intended for public companies down to private organizations would be harmful, costly and impractical. After all, Sarbanes-Oxley and spin-off regulations were intended to protect the investing public, a constituency that would probably feel no impact from the financial collapse of a private firm. Different motivations exist in private organizations where there is less of a focus on meeting short-term targets.

The AICPA has opposed copycat legislation at the state level on the grounds that it is inconsistent with the Uniform Accountancy Act and would lead to myriad regulations that make it difficult for companies and their CPAs to conduct business in multiple jurisdictions. But CPAs acknowledge that the ripple effect is likely. In a poll taken at the AICPA's annual meeting in April 2003, 47 percent of respondents said there was a high risk that private businesses would also be held to standards set by the Public Company Accounting Oversight Board, a five-member board established by Sarbanes-Oxley and charged with setting and enforcing audit standards for public companies.

Even if private companies are not mandated to comply with prevailing standards of sound corporate governance, many business leaders will opt for voluntary compliance. "Because Sarbanes-Oxley is the standard for public companies, it's becoming the standard for private companies, too," notes Bob Shepler, director of federal affairs for Financial Executives International.

## A Final Word

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Sarbanes-Oxley may not affect private firms directly, but there is much they can learn from its spirit. Proactive companies will view the legislation not as a threat or obstacle but as an opportunity to improve their effectiveness. They know their customers, shareholders and other key stakeholders increasingly expect firms to uphold a reputation for openness and integrity. This is not a trend that is likely to be short-lived. The most successful private companies will recognize that voluntarily adopting accepted reform standards is simply good business.

# Interview Sources

Robert Half International would like to acknowledge the following individuals for offering their insights into the impact of Sarbanes-Oxley on private business. Their contributions are greatly appreciated.

**Sheri Bango**, director of state societies and regulatory affairs, American Institute of Certified Public Accountants

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**Carol Sigmann**, executive officer, California Board of Accountancy

**Bob Shepler**, director of federal affairs, Financial Executives International

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