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Private Companies and the Sarbanes-Oxley Act of 2002
What a CEO Needs to Know, Now!

The Sarbanes-Oxley Act of 2002 (SOX) is the most recent Federal legislative effort to regulate corporate ethics aimed at restoring investor trust and confidence in public companies. SOX pertains to companies whose shares are publicly traded in the United States but parts of the legislation are beginning to affect private companies as well.

Before you read what parts of the SOX legislation apply to private companies, you should know why private companies cannot afford to ignore the issue. There are four events that can force private company CEOs and their Boards to consider voluntarily implementing SOX. As you would suspect, the four events concern a potential financing event. They include:

1. IPO.
2. Merger with or acquisition by a public company or private company with public company aspirations.
3. Bank, lease, or late-stage financing event.
4. Sales to government, or to large to mid-size corporate entities.

While no government can truly regulate personal or corporate ethics, SOX does specify a variety of requirements that businesses must follow to ensure the accuracy of information along with increasing the responsibility for accurately portraying financial results. SOX strengthens securities laws by including rules of corporate conduct, certification, oversight requirements and severe personal criminal penalties (fines and imprisonment) for violation.

Two issues found in the SOX legislation that warrant brief mention here affect a corporation's relationship with their legal counsel and their auditor. Section 302 requires confidential reporting mechanisms for in-house or outside legal counsel to report any evidence of a material security laws violation that they find in the course of their work for a particular client.

A better-known provision requires an Oversight Board that will establish auditing and quality control standards that include monitoring ethics and independence issues. Accounting firms that audit public companies must be registered, submit to inspections, and be subject to disciplinary sanctions. Every company should expect fee increases to compensate for the increased liability and compliance costs. Private companies should also expect closer scrutiny by accounting firms, especially for financing and internal control issues.

There are four key provisions of SOX that apply to public companies and parts of which will apply to private companies:

1. Corporate Conduct Policies, with rules relating to personal loans to Executive Officers and Board Directors.
2. Certification Requirements by CEO and CFO.
3. Mandatory internal control structure and auditor attestation.
4. Board of Director and Audit Committee Independence.

There are significant costs that will be incurred by public companies to become SOX compliant. In some corporations, there are significant changes that need to be made to their Board composition, their senior financial and legal officers, and in some cases their corporate culture. There is a major shift of accountability from the designated staff or department to the entire Board of Directors and senior management. With the severity of criminal fines and imprisonment, coupled with the resources necessary to monitor compliance with SOX, the legislation is expected to encourage the desired behavior. Any private company that is contemplating a public offering will need a much longer lead-time to ensure SOX compliance.

The practicalities of good corporate governance, ethical behavior, and compliance with the SOX rules and regulations can be difficult to impose, and expensive to implement and monitor. Even those companies that have had a Code of Ethics and internal controls are finding the process to implement new procedures that can withstand audit is costing several million dollars. This cost does not include the expense of finding new board members, changes or increases to board member compensation benefits to ensure compliance, or other ancillary changes required to comply with the legislation. The earlier in a corporation's life the appropriate behavior, rules and processes are implemented the less intrusive and expensive thereby allowing the company to concentrate its efforts on growing and managing the business.

Additionally, the personal liability to the public company officers along with the potential of forfeiting certain bonuses and profits and a 20-year prison term for violating the laws has provided the impetus for making all parties to the transaction certify their part of the deal. One person's interpretation: "It is no longer adequate for sales and marketing to only sell and let the bean counters worry about the rules."

The entire corporation is responsible for ethical decisions to grow the business but the atmosphere begins with the board and top management. The CEO and CFO must then certify that they are monitoring the company to ensure the rules are followed.

For those private companies that believe the exit for venture investors is an IPO, you may no longer be able to wait until the S-1 is filed to find your CFO, bring on independent board members and get your statements audited for the first time. Not only will you need to adjust your budgets for higher audit costs since only those firms that have been registered by the Public Accounting Oversight Board will be able to audit your financial statements; you will also need sufficient financial staff to maintain an efficient internal audit department because you as CEO must certify your company has effective internal controls. In addition, your auditor will need to confirm your evaluation of the internal controls.

According to companies that are in the throes of trying to comply with the regulations, the two most difficult issues are finding independent board members who will accept the liability and time commitment for these positions, and establishing the electronic systems to meet the internal control requirements. For a mid-sized start-up, experience has shown compliance typically takes approximately 9 months.

For private companies that believe they will be acquired by a public or near-public company, the valuation placed upon the non-SOX compliant acquired company is being discounted up to 20-25%. Some public companies that have depended upon acquisitions as a means to achieve top-line growth have stopped all acquisition activity for the next twelve months to get their own houses in order. Others are pursuing a purchase of technology only and will not merge operations due to already complex internal audit procedures. Escrows are being established that set aside 20% or more of the purchase price – up from 10-15% – and they are being held in escrow for 18 to 24 months, rather than one year. Several acquirers are also adding the cost of implementing SOX to the 20% holdback for liabilities. Not only are valuations lower today than a few years ago, but SOX has added another costly factor to mergers.

The CEO and CFO certification requirement has led to sub-certifications by other company employees responsible for particular parts of the company strategy or operations. In some companies for instance, sales and marketing employees are being required to certify that there are no offers for sale of product or services that have changes to the company's standard contract. They must disclose any side letters or negotiations for waivers of the contract and face dismissal for inaccurate certification. The CEO and CFO certifications will then be dependent upon sub-certifications such as these to be able to execute their certification. The granularity of the entire process is what is driving increased escrow amounts and longer escrow time period.

Late-stage investors are considering the financial costs of implementing SOX when determining to invest in prospective companies. They and their investors expect a shorter time to liquidity and know that non-SOX compliant companies will extend their exit estimations by at least 9 months and maybe longer.

Financial institutions routinely ask for certification of financial information but now are considering further evidence of accuracy and disclosure of all relevant information.

The best reason to adopt many of the SOX requirements early may be to begin a private company's corporate life on the right foot with good corporate governance and conduct with minimal cost. The second best reason is surely the ability to sell to major customers. There are state and local government agencies that have already changed their RFP process to require vendors to comply with certain portions of the SOX legislation. While it is too soon to tell if Fortune 100 or 1,000 companies will adopt these measures in the near future, it is not too soon to determine the best way to prepare for this corporate behavior change.

The sections of the SOX legislation that private company CEOs should consider implementing as soon as practical are as follows:

1. Policies and procedures. Establish a Code of Ethics for your company that cover confidentiality issues, fair treatment of employees, customers, suppliers and competitors, conflict of interest, protection of company assets, compliance with laws, and reporting unlawful or unethical behavior. Your company also should have a Whistle Blower Policy and a Record Retention and Destruction Policy. These policies should be published for all employees at a minimum, but not necessarily pubic announcement.

2. Personal loans. Eliminate any loans, personal guaranties or unusual arrangements to Executive Officers and Board Members as soon as possible. This is especially applicable for any company that desires to be acquired or merged in the next year. For any Officers who still have loans outstanding, you will not be named an Officer of the merged company since you will be unable to comply with Section 16 of the SEC Act of 1934. While not required as a private company, outstanding loans can hinder a potential acquisition at best or reduce the valuation price paid.

3. CEO and CFO certification of financial statements. Financial Institutions may already require CFO and or CEO certification for bank or lease lines. A sub-certification process may be appropriate for sales, marketing, engineering and service, in addition to the finance and administrative departments. Growing companies depend upon the contribution of each of the various departments without the CEO or CFO approving every nuance of every deal. The various departments should be able to certify that they have followed the Company's policies and procedures without

any material fact omitted so that the CEO and CFO may rely upon those sub-certifications. While private company CEOs and CFOs are not subject to SEC criminal penalties for false certifications, they are subject to other criminal penalties for false or misleading statements.

4. Implementation of an Internal Control System with the goal of being COSO (Committee of Sponsoring Organizations of the Treadway Commission) compliant by the time of a financing event. This element, alone, if not in place will often subtract 15% from an acquisition price. To add an efficient system of internal controls and a culture of SOX compliance while a small company is much more cost-effective than waiting for a pending event that will inevitably influence acquisition price. This process is the most invasive and time-consuming since it involves every department in the company from the Board of Directors and CEO to every individual contributor, irrespective of their position. Information technology drives many of the efficiencies of small and large businesses and must be included in the assessment of internal control process.

5. Begin identifying and recruiting independent board members. Some companies are experiencing a 9 month or more delay in being able to recruit independent board members, especially those that fulfill the financial expert profile due to enhanced responsibilities, increased time commitment to perform the duties and insufficient compensation. Even when compensation is increased, the potential liability is hampering recruiting effort.

Business and personal ethics have always been integrated into the fabric of those companies whose stock you want to own because they represent a good investment; the investor can trust those companies' progress and financial reports. SOX will not obviate the need for a good business model, customers who want to buy the product or service, or employees who manage and operate the company. It is hoped that this legislation will provide a framework and standard to measure a company's moral compass. Private companies will find many of the SOX requirements will become de rigueur for them sooner, rather than later. The best course of action is to be prepared before one of your partners or financial institutions mandates compliance – at that point it may be too late!

Contact Co-Capital Partners for more information about this issue and experts in particular fields that can help your company institute the appropriate policies at the appropriate time in a cost effective manner.

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