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INVESTMENT BANKERS

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Sarbanes Oxley Matters to You

In response to the Enron and WorldCom scandals, Congress passed the "SOX" Act. How it affects private companies may surprise you.

by Mark D.Working

In July of 2002, Congress enacted sweeping corporate governance and financial reporting reform legislation known as the Sarbanes-Oxley Act of 2002 ("SOX") in response to a litany of public company financial scandals (e.g. Enron, Worldcom, Tyco, Adelphia, Global Crossing). According to the Senate report on the legislation, the intent was to "improve quality and transparency in financial reporting and independent audits and accounting services for public companies," and "increase corporate responsibility and the usefulness of corporate financial disclosure" in order to boost investor confidence.

SOX set in place a regulatory regime that holds corporate officers personally accountable for the accuracy and completeness of financial disclosures, and not in some minor way. The penalties for deceit or inattention are quite punitive, as much as $5 million in fines and as many as 20 years in prison. Moreover, both the CEO and CFO risk forfeiture of bonuses and/or profits from company stock sales for any "material" non-compliance with financial reporting requirements.

SOX has materially impacted the attitudes of public company decision makers, particularly with regard to the costs and risks that they are willing to undertake in the acquisition of a privately held business.

It is arguable whether integrity can be legislated, but Congress's intent was to ensure that managers would never again have an incentive to pull the wool over the eyes of investors and regulators in the manner achieved at Enron and a host of others.While public company managers have been scrambling to comply, their private company counterparts have watched from the sidelines with lukewarm interest, comforted by the belief that SOX strictures don't apply. It turns out that this is a shortsighted view. SOX has materially impacted the attitudes of public company decision makers, particularly with regard to the costs and risks that they are willing to undertake in the acquisition of a privately held business. Business owners unaware of the implications of SOX may unknowingly narrow the potential market for their firm and sacrifice significant value.

SOX requires a fully documented system of practices, procedures, controls and certifications designed to insure fairness, accuracy and completeness of disclosures to shareholders and others.

	SOX REQUIREMENTS	
MANAGEMENT MUST:	**SECTION 302**	**SECTION 404**
Evaluate the responsibility for, and the design and effectiveness of,	Disclosure controls and procedures	Internal controls over financial reporting
Assess the integrity of	All material financial and non-financial information included in public reports	Financial statements
Routinely review controls	Within 90 days from filing date	Each quarter
Document evaluations and disclose	Any material misstatements	Any significant deficiencies or material weaknesses in financial controls
Certify SOX compliance	Quarterly by the CEO and CFO	In an annual report by the CEO and CFO
Audit and attest	Not required	Annually by an independent third-party auditor

SOX REQUIREMENTS

The SOX Act spans a broad spectrum of topics—auditor and audit committee independence, executive compensation, corporate responsibility, and enhanced financial disclosures and certifications. From a private company perspective, the provisions of Sections 302 and 404 relating to accounting practices and financial disclosures seem the most pertinent. SOX requires a fully documented system of practices, procedures, controls and certifications designed to insure the fairness, accuracy and completeness of disclosures to shareholders and others.

The documentation and effectiveness of a public company's internal control processes are annually subject to a mandatory independent audit. Any material weakness in the internal controls and non-compliance requires a public disclosure detailing the deficiency.

SOX AND THE ACQUISITION PROCESS

For public company acquirers, uninterrupted SOX compliance has become a paramount consideration. The fundamental requirements of SOX apply to a new acquisition, as of the closing date. The acquiring company is obligated to identify and disclose any material deficiencies in the acquired business's internal financial controls in any of the following areas: selection/application of accounting policies, antifraud programs, control over non-routine/systematic transactions, and controls over period-end financial report processing. The timeframe in which the acquirer must correct or disclose any significant deficiencies or material weaknesses varies depending on whether or not the acquired business is a "material" portion of the combined business. If the acquisition is "material" to the overall business, then immediate assessment and disclosure must be made, along with an estimate of compliance costs. Disclosure of concerns for immaterial acquisitions can be deferred for no more than a year.

The acquiring company's executives have

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two primary worries. First, the acquisition introduces a new and unknown set of employees and accounting/reporting procedures and, therefore, heightens concerns regarding both control and accuracy. Second, uncertainty surrounding controls and accuracy breeds doubt about the time and cost required to bring the acquired company into compliance. The upshot is that accounting due diligence has become much more rigorous, and any lingering uncertainty is likely to be reflected in more onerous transaction terms (representations, warranties and indemnities), a more protracted process, and a value penalty. If the answers to SOX concerns are not reasonably clear-cut, the field of prospective buyers will shrink, possibly eliminating all except those who view the transaction as immaterial.

RECOMMENDATIONS

Maximizing the value of a privately owned company in a sale transaction depends on engaging those parties who can derive the greatest benefit from the business combination. Often, the best strategic fit—therefore the highest value—is provided by a public company. This means that one must pay attention to SOX and address any deficiencies. We recommend the following:

- Audited financial statements bearing the unqualified opinion of a known and reputable regional or national audit firm.
- Substantive annual management letters from the auditors, together with documentation of management's actions to address recommendations and issues.
- An assessment of SOX compatibility from the audit firm, including an estimate of the activities, time, and cost to become compliant.
- Improvements to a company's financial controls and reporting processes with special attention given to:
  - Documentation of internal financial controls;
  - Elimination of manual and judgment procedures in month-end closings; and
  - Elimination of year-end audit "clean up" of accrual processes.

Our advice is to always conduct the due diligence that a buyer will require prior to beginning sale discussions. Just as one would conduct an environmental assessment and correct any deficiencies before beginning the process of selling a business that owns real property, the same applies to SOX. A prudent owner will know the deficiencies in the company's financial systems and will be working to correct them, rather than permitting an outside party to surprise the seller with a list of problems and an adjustment to the transaction timing or economics. ❖

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ABOUT ZACHARY SCOTT

Zachary Scott is an investment banking and financial advisory firm founded in 1991 to serve the needs of privately held, middle-market companies. The firm offers a unique combination of in-depth knowledge of the capital markets and industry competitive dynamics, sophisticated analytical capabilities, and proven expertise in structuring and negotiating complex transactions. For more information on Zachary Scott, please go to ZacharyScott.com.

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