



CFO Best Practices- Implementing Sarbanes- Oxley Compliance Techniques at Your Private Company

David S. Bakst

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About the Webinar Speaker

- About David S. Bakst, Partner, Mayer Brown LLP
- Focuses on a wide variety of domestic and international securities offerings and corporate governance matters for domestic and international companies of all sizes
- Works with clients from a broad range of industries including financial services, oil, gas and petrochemicals, alternative energy, telecommunications and technology
- Routinely advises clients in the IPO process about the corporate governance aspects of the transition to public company status
- Over 15 years of capital markets experience
- Pragmatic and sensible approach to adopting Sarbanes-Oxley best practices

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Overview

- Adopting key Sarbanes-Oxley (“SOX”) best practices can provide significant benefits
- SOX-compliant best practices are important to consider if your company is planning to go public or become the target of an acquisition
- Third parties such as investors and insurers may insist on internal controls and best practices that are compliant with SOX
- SOX-compliant best practices may be required for certain state and federal contract eligibility
- Potential high-quality Board members may be reluctant to serve without SOX-compliant best practices
- SOX-compliant best practices generally give your company a better chance of avoiding or successfully defending against litigation

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What to Know

- Key action items for consideration:
 - Adopt a corporate Code of Business Conduct and Ethics
 - Appoint independent Board of Directors
 - Establish an independent Audit Committee
 - Establish SOX 404 Management Assessment of Internal Controls
 - Implement SOX 302 and 906 CEO and CFO Financial Statement Certifications
 - Adopt whistle-blowing procedures

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Key SOX Provisions

- Section 301 – Role of Independent Directors
- Sections 302 and 906 – CEO/CFO Certification of Financial Statements
- Section 404 – Management Assessment of Internal Controls
- Section 409 – Real Time Issuer Disclosures
- Section 406 – Adopting a Code of Business Conduct and Ethics
- Section 802 – Criminal Penalties for Altering Documents
- Sections 806 and 1107 – Protection for Whistle-Blowers

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NACD Principles

- National Association of Corporate Directors (“NACD”) has promoted Key Agreed Principles which state that governance structures and practices should:
 - Be designed to position the Board to fulfill its duties effectively and efficiently
 - Be transparent
 - Be designed to ensure the competency and commitment of directors
 - Be designed to ensure accountability to shareholders and objectivity of Board decisions
 - Provide some form of leadership for the Board distinct from management

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NACD Principles (contd.)

- Promote an appropriate corporate culture of integrity, ethics and corporate social responsibility
- Support the Board in determining its own priorities and resultant agenda and information needs and assist the board in focusing on strategy
- Encourage the Board to refresh itself and protect against entrenchment
- Encourage meaningful shareholder involvement in the selection of directors
- Encourage communication with shareholders

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What to Know

- Corporate Code of Business Conduct and Ethics
- SOX requires the adoption of a written Code of Business Conduct and Ethics (“Code”) applicable to senior financial management that promotes honest and ethical conduct
- Adopting such a Code sets the tone for your entire company from management down and is an inexpensive way to provide comfort to the business world
- Consider a Code that makes sense for your company – don’t just adopt an “off the shelf” Code
- Ensure that all employees are advised of the Code and that it is enforced
- Your company will have a stronger defense if faced with litigation alleging corporate misconduct if it can point to both a Code and diligent attempts to enforce and follow it

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What to Know

- Independent Board of Directors
 - SOX emphasizes the importance of independent directors and requires at least one member of the Board to be independent
 - Both NYSE and NASDAQ require that listed company boards have a majority of independent directors
 - Appointing independent directors can preserve objectivity and give your company valuable insights from seasoned executives who may have creative solutions to your problems based on prior experience
 - Having independent directors may be a requirement of certain banks or other financial institutions in order to obtain financing
 - Well-qualified director candidates are keenly aware of the risks involved in serving on boards and may be reluctant to serve unless the company has extensive SOX-compliant best practices and procedures in place

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What to Know

- Independent Audit Committee
- SOX requires all members of the Audit Committee to be independent directors (including a financial expert) and to serve as the primary liaison between the company's accountants and the Board
- Adopting an Audit Committee charter that mirrors these requirements is considered best practice and may be required by lenders or by your company's outside accountants
- Consider appointing at least one Audit Committee member who is a financial expert who can question and communicate effectively with your company's outside accountants and auditors
- The lack of an independent Audit Committee could be raised by a plaintiff's attorney in the event of a claim of financial mismanagement or fraud
- Adopting SOX-compliant best practices in this area sends a strong message to the investment community regarding the financial and ethical position of your company

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What to Know

- Independent Audit Committee (contd.)
- Simply forming an independent Audit Committee is not sufficient to protect your company
- The Audit Committee must appreciate the large and complex financial risks taken by your company and ensure that they identify the key judgments made by management and external accountants in preparing the company's financial statements
- To be effective, Audit Committees should ask their external accountants/auditors for specific information concerning:
 - repeatedly occurring transactions
 - material items where accounting literature allows alternative methods of presentation
 - material differences in significant accounting policies between the company and its main competitors

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What to Know

- SOX 404 Management Assessment of Internal Controls
 - SOX 404 requires companies to maintain and certify to a system of internal controls to ensure the accuracy of their financial statements and requires such companies' outside auditors to attest to and report on the effectiveness of the companies' internal controls
 - Adopting a system of internal controls to review and manage the operation of the internal audit function will lead to greater accuracy and comfort in your company's financial statements
 - Management certification of an established system of internal controls may be required by external accountants and auditors in order to mitigate their risk
- SOX 302 and 906 require CEOs and CFOs to personally certify as to the accuracy of the company's financial statements
 - CEO/CFO certification of your company's financial statements can instill confidence in potential investors and business partners that management takes responsibility for the accuracy of the statements

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What to Know

- Whistle-Blowing Procedures
- SOX requires companies to adopt written procedures for how employees may report wrongdoings within the company
- Consider adopting a whistle-blower policy that provides an avenue for reporting activity to an independent person not directly related to management such as a designated outside director, the company's outside accountants, or an independent compliance phone hotline
- Implementing and enforcing whistle-blowing procedures is not costly and indicates that your company takes its ethical duties seriously and may provide a stronger defense against potential litigation alleging corporate fraud

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Action Plan

- Be aware of the stage of growth of your company and its financial ability to become SOX-compliant
- Consider your industry and the SOX-related requirements of the companies with which you do business
- Consider your timeline for becoming SOX-compliant in the context of a potential IPO, merger or acquisition
- In adopting a Code of Business Conduct and Ethics, think about the culture and personality of your business
- Weigh the potential costs associated with appointing independent directors with the benefits they will provide to your company
- Consider paying more to financial experts serving on your Audit Committee
- Remember that compliance with SOX provisions has become best practice among many private companies and is often expected by third parties you may want to do business with
- View implementation of these best practices as an opportunity to improve and strengthen your company

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FAQs

- SOX compliance is not required, so there is no benefit to me to become so
- Small, private companies have no use for SOX-compliant procedures
- Becoming SOX compliant is too expensive and the benefits would not overcome that cost
- We have had our own internal controls in place for many years and we seem to be doing just fine
- We are not planning an IPO so why would we need to become SOX-compliant?
- We are not planning to seek an acquisition exit-strategy for at least another few years

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Case Studies

- Cargill Inc. – Adopted a “hybrid system of corporate governance between public and private” including publicly disclosing material details from its off-balance sheets dealings
- Carlson Systems Corp. – CFO stated that they appointed independent directors for two reasons: (1) to gain business expertise and insight and (2) to hold accountable the top management, who are often family members, major shareholders and employees
- Continental Grain Company– Implemented a whistle-blower hotline, updated their code of conduct and maintains a majority independent board in order to comply with SOX’s requirements for how to be a “good corporate manager and a good corporate director”

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Considerations

- Full compliance with all SOX requirements is a costly and time-consuming process but fortunately private companies have the flexibility to choose which SOX-compliant practices will most help your business
- Adopting certain SOX-compliant policies such as an ethics code and whistle-blowing procedures are not costly and generally involve one-time upfront expenses
- Other SOX-compliant best practices such as hiring independent directors can be a costly process, particularly because many potential directors will require the company to purchase expensive D&O insurance
- Despite the varying costs associated with compliance, once implemented, these best practices can strengthen your company's operation, efficiency, reputation and can add value, particularly if you are looking towards an acquisition exit-strategy

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Conclusions

- Adopting SOX-compliant internal corporate governance best practices “is rewarded by the market, and generates performance improvements in the long run.”*
- Private companies have the benefit of adopting a hybrid approach and choosing the best provisions to implement
- Principled approach tailored to specific company needs and objectives is critical for success

* See “The Vote is Cast: The Effect of Corporate Governance on Shareholder Value” May 2010, by Vincent Cuñat (London School of Economic), Mireia Gine (University of Pennsylvania) and Maria Guadalupe (Columbia University)

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