Antiphony℠

What Private Companies Need to Know About Corporate Governance

Introduction

As a result of the recent slew of high-profile business scandals, corporate governance is a hot topic these days. While publicly traded companies are facing a proliferation of new federal regulations and stock exchange rules, private companies are facing equally intense, though less formal, pressures for corporate governance reforms from gun-shy investors anxious to avoid any unpleasant surprises and ultimately to safeguard their investments.

In a nutshell, corporate governance is how companies direct and control their operations to ensure the honesty, transparency and accuracy of their business results. It sounds straightforward, and given today's skeptical business climate, most companies are beginning to preach the corporate governance gospel with a vengeance.

However, when it comes to actually implementing the myriad of new corporate governance regulations, many public companies are still struggling to get up to speed. And it's no wonder. Corporate governance touches upon many diverse facets of a business that require specialized expertise, including the role of corporate boards, financial reporting, internal metrics and controls, and corporate values.

The recently enacted Sarbanes-Oxley Act spells out new responsibilities for executives and board members of publicly traded companies. To decipher how this law will impact their businesses, public companies are turning to armies of specialized accountants and lawyers for help. However, many private companies, lacking deep pockets for expert advice, are wrestling with how to comply with the spirit of these new reforms to satisfy their investors, who are increasingly holding private companies to the same standards of accountability as their public counterparts.

In this Antiphony white paper, we will explore some of the specific issues private companies are facing as they create the corporate governance structures, policies, and processes to minimize their legal liabilities and mitigate fraud, error, and undue risk.

Is Your Board of Directors Up to the Job?

A post-mortem analysis of the recent wave of corporate malfeasance yields a simple truth: Many corporate boards were clearly asleep at the wheel while scandalous misdeeds occurred on their watch. As a result, lawmakers felt compelled to draft corporate governance reforms, such as the Sarbanes-Oxley Act, which spell out new heavy-duty responsibilities for corporate boards across America.

For public companies, these strict reforms are designed to ensure that corporate boards will no longer tolerate unchecked executive power and will aggressively protect shareholder interests. New stock exchange rules call for the majority of a company's directors to be independent of the firm. Other regulations require the adoption of new audit committee standards, such as requiring a minimum number of "financially literate" directors and defining new responsibilities for overseeing corporate audits. In short, these tighter rules are designed to ensure that directors can no longer get away with shoddy corporate oversight.

Private companies, on the other hand, are not technically bound by these new rules; however, the underlying premise behind them still applies. Increasingly, investors are insisting that directors of private companies be more vigilant. But in this new era of corporate governance, private companies are facing some unique challenges when it comes to their boards.

The trick to building the ideal board is recruiting high-caliber, independent directors.

For starters, private companies typically build their boards by adding or subtracting directors with each new round of financing. However, now more than ever, companies must make sure they have the right mix of directors on their board who are not only managers and investors, but honest-to-goodness independent directors who have no formal or informal ties to the company. Also, just like public companies, private companies need specific audit and compensation committees that include "financial experts" to help sort out today's increasingly complex financial issues.

The trick to building the ideal board, of course, is recruiting high-caliber, independent directors. In today's cautious environment, many potential candidates are wary of the increased liabilities associated with serving on a board and subsequently vouching for a company's books. Because the responsibilities of directors are becoming more complex and time consuming, the task of recruiting them is becoming more difficult. Nevertheless, it is critical that private companies recruit a well-balanced board that is clearly not beholden to management. So, private companies must take whatever steps are necessary to recruit the right directors, including offering more generous incentive packages. In the long run, companies that assemble qualified and independent boards will be rewarded by their investors.

Who Qualifies as an "Independent" Director?

The Sarbanes-Oxley Act defines an "independent" director as an individual who does not receive any consulting, advisory, or other compensatory fee from the company, other than for service on the board, and as an individual who is not affiliated with the company or any of its subsidiaries.

And, Who Qualifies as a "Financial Expert"?

A "financial expert" is defined as an individual who has the same education and experience as a public accountant, auditor, chief financial officer, comptroller, and principal accounting officer or as an individual who has held a position performing similar functions.

Financial Reporting in the Post-Enron World

In August, the SEC took the unprecedented step of requiring the CEOs and CFOs of the nation's top public companies to certify the accuracy of their financial statements. This historic action may be only the first in a series of measures designed to address overly aggressive accounting practices, unchecked conflicts of interests and ethically challenged auditors. The financial reporting function is now under increased scrutiny for all companies, both public and private.

For most companies, certifying the accuracy of their financials is not as straightforward as it seems. Executives must take many steps to guarantee that the information they sign off on is accurate and presents a clear, detailed picture of how the company is actually doing.

The Sarbanes-Oxley Act details a multitude of new corporate governance reforms designed to restore investor confidence by ensuring the credibility of financial statements for public companies. Corporate executives, specifically CEOs and CFOs, now must certify that their financials are accurate to the best of their knowledge and that they contain all necessary material information to provide a fair picture of the company's financial condition.

Additionally, the certification must indicate that the executives have created and actively maintained internal controls on financial reporting. Also, executives must acknowledge their obligation to discover and report fraud inside their organization.

Technically, the Sarbanes-Oxley Act only applies to public companies. However, investors in private companies, many of whom were hoodwinked themselves by misleading financial statements, are increasingly insisting that private companies also adhere to these stricter new standards.

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As a first step, executives and board members must fully understand the implications and potential liabilities associated with the new financial reporting requirements. In the recent Enron debacle, board members and executives were sued for their role in misleading investors. At a minimum, all public and private companies should review their Directors and Officers Liability Insurance policies so that they understand their legal exposures and that their insurance coverage is adequate in the event of an investor lawsuit.

Staying Current on the Fundamentals

For many executives and board members, the last time they reviewed the nuances of accounting was years ago in college. Given the increased liabilities associated with overseeing a company's financial results, it's imperative that CEOs and board members have a firm grasp on how to interpret and challenge the accounting details that lie behind a company's income statement and balance sheet. To that end, an executive education course that covers the following topics may be in order: a review of generally accepted accounting principles (GAAP) and the application of GAAP in connection with estimates, accruals and reserves; how to calculate retained earnings; and how to create internal accounting controls.

Second, to restore investor confidence, companies need to take care to avoid overly aggressive accounting practices that technically comply with GAAP, but ignore the underlying financial principles and paint a deceptively rosy picture of a company's financial condition. Additionally, when creating a company's financial profile, there is room for legitimate discretion in areas such as valuing a company's assets (such as a company's brands, goodwill, and intellectual capital) as well as important bottom line figures such as earnings and profit results. But be prepared to share your assumptions with your investors. Increasingly, investors are demanding to see detailed explanations of a company's key business assumptions as well as the strategic and operational risk factors that may influence future financial performance and impact shareholder value.

And finally, to assure that financial statements are credible, companies need to develop stringent internal controls to push responsibility for the accuracy of financial statements further down in the company. All employees who contribute key information to a company's financial picture or who actually help prepare a company's financials need clear guidelines for assuring accurate, complete, and timely financial information. And, prior to signing off on their financials, CEOs and CFOs should conduct "internal due diligence" meetings with their key executives to uncover any potential problems.

In short, investors are demanding clarity, transparency, honesty, and accuracy when companies report their financial results. As a result, companies need to make financial reporting a top priority. In the long run, these efforts will pay off as investors cut the cost of capital for companies that adhere to conservative accounting policies and straightforward financial reporting.

Internal Metrics and Controls – Who's Minding the Shop?

In the heyday of early 2000, bullish investors eagerly poured money into companies, often without digging deep into the operational aspects of the business. Times have changed. Once exuberant investors, haunted by troubled investments, are now demanding increasingly sophisticated controls to identify problematic issues and potential conflicts of interests. As a result, CEOs and CFOs are looking for new procedures and metrics to assure skittish investors.

These developments underscore the importance of metrics and controls – the tools for creating a factual basis for measuring a company's overall performance and accountability. Most companies today utilize some sort of metrics to measure their business, but in the current climate many companies are taking a closer look at their overall framework for corporate controls and reporting.

To begin with, companies need to create a performance benchmark plan that details the strategic and operational risk factors as well as the underlying metrics that are critical for measuring the company's growth. At a minimum, these metrics should be formally reviewed quarterly with clear explanations detailing the reasons for both positive and negative variances.

Companies also should determine the relevant operating metrics associated with each function and require that the executive responsible for each area certify in writing the accuracy of the data. As a result, when a company compiles its key metrics for a board meeting, there should be no questions about the validity of any of the measurements.

Metrics and controls are important tools for helping executives and board members understand how strategic, operational, and investment initiatives impact shareholder value. For both internal and external audiences, vigorous monitoring and reporting of key corporate metrics is an indispensable barometer for determining the well being of a company.

Beyond "Mom and Apple Pie" – Institutionalizing Corporate Values

Corporate governance entails much more than just the role of corporate boards, financial reporting, and internal controls; it also encompasses how companies define the real boundaries of acceptable behavior for their employees. Many companies will pontificate endlessly about their "mom and apple pie" corporate values like honesty, fairness, and integrity. The recent slew of headlines about ethically challenged executives suggests, however, that some companies are not living up to their professed ideals.

For many private companies, defining corporate values and creating a formal ethics policy never make it to the corporate priority list. For other companies that do have policies, they often remain buried deep within an employee handbook. So, the question becomes, how can companies be sure that their employees will avoid unethical behavior and have a clear sense of where to draw the line about what is right and wrong?

Companies must have a formal ethics policy to guide their employees' understanding of how the company's business principles apply to what they do. This is now an SEC requirement for publicly traded companies, but private companies would be well advised to follow suit. Senior executives also must put in place policies, structures, and procedures so that corporate ethics and values are consistently and regularly communicated and reinforced. In addition, as a system of checks and balances, companies should create a mechanism for employees to confidentially report any dubious business practices they may encounter to the audit committee. Finally, executives must lead by example, creating an environment where employees can question ideas in a non-threatening environment and are rewarded for incorporating the company's core values into their business decisions.

In short, to promote honest and ethical conduct, companies need to do more than offer lip service to their corporate values. Companies must clearly and consistently articulate guidelines for what is right and wrong, and be sure that all of their corporate actions – from the biggest and most strategic decisions down to the tiniest details – pass the litmus test for ethical behavior.

Summary

The next few years promise to bring dramatic and significant changes to corporate America. New laws and regulations are redefining how public companies govern themselves, and investors in private companies are becoming increasingly proactive about monitoring their risks and protecting their investments. As a result, all companies, both public and private, must re-evaluate their corporate governance policies and procedures to minimize their legal liabilities and mitigate fraud, error, and undue risk.

Ten Things Private Companies Should Do to Improve Corporate Governance

1. Make sure executives and board members are up to speed on the new corporate governance regulations and fully understand the ramifications of the new Sarbanes-Oxley Act, SEC regulations, and stock exchange rules. Even though they technically apply to public companies, many investors expect private companies to conduct themselves like their public counterparts.

2. Take a close look at the composition of your board. Ideally, private company boards should consist of a majority of non-management members. Also, does your board include honest-to-goodness independent directors and "financial experts," and do you have formal audit and compensation committees that meet at least quarterly?

3. Review your Directors and Officers Liability Insurance policies. Make sure you understand your legal exposures and your insurance coverage will adequately cover an investor lawsuit.

4. Sign up your executives and board members for an executive education course on accounting and finance. Given the increased liabilities associated with overseeing a company's financial results, it's imperative they have a firm grasp on how to interpret and challenge the accounting details behind a company's income statement and balance sheet.

5. Develop stringent internal controls to push responsibility for the accuracy of financial statements further down in the company. All employees who contribute key information to a company's financial picture or who actually help prepare a company's financials must have clear guidelines for producing accurate, complete, and timely financial statements.

6. Take care to avoid overly aggressive accounting practices that technically comply with GAAP, but ignore the underlying financial principles and paint a deceptively rosy picture of a company's financial condition.

7. Create a performance benchmark plan that details the strategic and operational risk factors as well as the underlying metrics that are critical for measuring the company's growth. At a minimum, these metrics should be formally reviewed each quarter with clear explanations detailing the reasons for both positive and negative variances.

8. Develop a formal ethics policy so that employees understand how the company's guiding business principles apply to what they do. This is now a SEC requirement for publicly traded companies, but private companies would be well advised to follow suit.

9. Make sure you create a plan that consistently and regularly communicates your corporate ethics policy and values. Don't bury your values in an employee handbook.

10. As part of a system of corporate checks and balances, create a mechanism for employees to confidentially report to the audit committee any dubious business practices they may encounter.

Antiphony[SM]

Antiphony Partners, LLC
200 Musket Lane
Wayne, PA 19087 USA
(610) 725-0358 • (610) 889-2299 (Fax)
info@antiphony.com