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The Business Value Manager

... **SPECIAL REPORT** ...

Sarbanes-Oxley: More Needless Regulations or A Nudge Toward Better Corporate Governance?

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Any federal legislation aiming to overhaul corporate governance should generally be viewed with caution, if not outright panic by corporate shareholders. Many investors and commentators provided this reaction to the new Sarbanes-Oxley Act, which was signed into law July 30, 2002. Much of this legislation was passed in response to scandals and accounting irregularities at Enron, Tyco, WorldCom, AOL Time Warner, Global Crossing, ImClone and Q West, as well as the collapse of accounting firm Arthur Anderson.

In general, this legislation applies to **public** companies and calls for greater objectivity in corporate boards, greater independence for auditors, increased control and participation by boards in financial reporting, and stiffer penalties for violations.

As the new policies and practices are implemented, the key concern for shareholders of private as well as public companies is how

effective these new regulations and procedures will be in assuring investors and ultimately in building shareholder value. With the increasing emphasis on verification, documentation and more formalized board policies and practices, the job of corporate director will become more time consuming

and challenging as accountability increases. Finding qualified directors, adequately compensating them, protecting them with appropriate insurance and then keeping their attention focused on key strategic issues, rather than merely compliance with the new regulations, will be major

factors influencing the success of companies in this new environment.

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"Too frequently, private company directors accept board positions as a friend or business acquaintance of an owner without recognizing their potential risks and liability."



What is already certain is that the role of public corporation boards of directors has changed forever. What is still uncertain is the long-term effect on corporate performance.

Sarbanes-Oxley's Initial Influence on Private Companies

While the new law applies primarily to **public** companies, many larger and more progressive **private** businesses are recognizing the need to conduct their corporate policies in a more formal manner. This transition is reflected in a recent study conducted by Robert Half Management Resources. Their survey of 1,400 CFOs of private U.S. companies revealed that 58% had taken or planned to take steps to achieve better control of accounting practices. Thirty six percent reported creation or expansion of internal audit functions and 23% had hired an independent firm for corporate governance consulting. Finally, 8% reported implementation of plans to restructure executive compensation packages.

Some private company boards are reacting to the June 2003 ruling by a federal judge in New York City that directors at the bankrupt Trace International Holding, Inc., a privately owned company, failed to provide proper oversight when they allowed the company's chairman and controlling shareholder to exhaust corporate funds through a combination of excessive

compensation, dividend payments and shareholder loans.

Also fueling the movement by private company boards toward a more formal and open governance and stricter accountability is their relationship with passive

investors, creditors, suppliers and customers, particularly when these entities are publicly owned. These changes also reflect the rapidly rising cost of directors' and officers' insurance and the carrier's requirement for more formal board policies to qualify for coverage.

Although limited data is available, it appears that some private companies are adding independent directors and creating audit and compensation committees where none previously existed.

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Sarbanes-Oxley's Silver Lining – The 4Q Decision Assessment©

While compliance with Sarbanes-Oxley may reduce your insurance premiums or even enhance your attractiveness to a potential investor, simpler steps are available and they can pay you bigger dividends. The following are four essential governance reforms, which comprise a process Evans and Associates calls the 4Q Decision Assessment©, that every private company should practice to enhance value.

Step One: Annually measure and manage your company's returns, risks and value.

To effectively build and harvest value in your private company, you must clearly understand what financial returns it creates for capital providers, how risky it is and what factors most influence that risk, and what your company is worth and what drives that value. Armed with this information, company leaders can devise strategies and establish policies to maximize their **returns**, minimize their **risk**, and in the process, build their company's **value**. Effective corporate governance requires this information.

Step Two: Focus on the future to drive value through formal corporate planning.

Private company owners and managers are frequently so engrossed in day-to-day operations, that their corporate planning is little more than preparation of an annual budget. This is comparable to driving very fast at night, in heavy traffic with no headlights – it's an accident waiting to happen. Owners and executives must focus on the future and in private companies, this requires particular attention in three critical areas. Owners must annually address **management succession** and objectively evaluate what management skills are required in the company currently and over the next three to five years. This is particularly critical in family businesses where gaps often arise.

Ownership transition issues – whether one or more shareholders want or need to sell their stock – should also be considered annually. This requires that they view their private company as an investment that at some point will generate cash returns through a sale.

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"Private companies that must deal extensively with creditors, passive investors, regulatory agencies or publicly owned customers or suppliers will experience increasing pressure to enhance board operating formalities and accountability.."

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Corporate Governance Improvement Priorities

This new legislation aims to improve corporate governance in the following major areas:

Selection of Directors

Most companies lack any standards for evaluation of director performance. Board members who routinely fail to attend meetings or make any material contribution tend to increase the power of the remaining directors and often the chairman in particular. Although director competence, experience and independence will come under increasing scrutiny, neither Sarbanes-Oxley nor other reform measures specify a formal mechanism for evaluating directors or forcing their removal.

Expanding Board Influence and Authority

With greater accountability placed on corporate boards, the likely effect is a shift in authority from senior company executives to boards of directors. Critics have already predicted that this will result in much more cautious board behavior as the increased scrutiny renders boards more risk averse. Many public company boards have already retained attorneys and consultants to advise them on their broadened authority and liability under the Sarbanes-Oxley reforms. Critics say this initial attention to the new compliance requirements is distracting board members from needed focus on company business. Early reports also indicate directors are becoming more active in company operations to enable them to make more informed strategic decisions.

Non-executive Board Chairs

To both increase the oversight provided by independent board members and reduce the influence of corporate executives, the roles of board chair and company chief executive officer are being separated. This organizational format tends to dilute the CEO's formal and informal power, and encourages more thorough board due diligence on key corporate decisions.

Direct Communication with Employees

To encourage early detection of questionable ethics behavior, a number of public companies have established direct links in the form of email or other types of hotlines for employees or investors to report alleged wrongdoings. Screening and

investigating such communications will be the major challenge in this process because, unless boards perform the function directly, it will be administered by management, which is the group it is intended to police.

Expanded Audit Committee Duties

Sarbanes-Oxley requires audit committees to change their auditor's managing audit partner every five years. Also, restrictions on non-audit services that a company's auditor can provide has left many CFOs searching for new sources of tax advice.

In general, audit committees must be much more vigilant and actively involved in reviewing financial statement data and internal control procedures. Sarbanes-Oxley prohibits audit committee members from taking fees from the company for anything other than board service. Ultimately, the work of the

audit committee is backed by that of the company's CEO and CFO, who are each required to certify the firm's financial statements under threat of civil and criminal penalties for false certifications.

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Executive Compensation

Increasingly, executives in public companies are being held

to much more measurable and strict standards of performance to justify their compensation. Company profits and actual versus budgeted performance are key criteria as well as the company's stock price. Executive bonuses have generally shrunk in recent years, reflecting weaker business conditions, with the popularity of stock option grants greatly diminished well.

Conclusion

The "Internet Boom", and accompanying "Stock Market Bubble," led to more excesses than investors and regulators would tolerate. The market has already punished many - Arthur Andersen is gone, the stock prices of the mismanaged companies have nose-dived and the careers, if not the fortunes, of many executives are ruined. The ultimate results, however, of this new legislation will take longer to play out.

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Legal Opinions Every Private Company Owner, Director and Executive Should Seek

While the Sarbanes-Oxley Act primarily legislates corporate governance and accounting regulations for **public** companies to protect their shareholders and employees, trends already indicate that **private** companies will face increased scrutiny as well. Sarbanes-Oxley increases the penalties for acts that were previously illegal, such as destroying or altering documents, and imposes stronger penalties and possible imprisonment for failure to disclose deceptive operating and financial practices.

Too frequently, private company directors accept board positions as a friend or business acquaintance of an owner without recognizing their potential risks and liability. These threats, however, can be significant, making it prudent for anyone serving as a private company director or executive to be familiar with pertinent laws and regulations.

Experienced corporate counsel can be invaluable and should be consulted for answers to the following questions:

To Whom and How is a Director Accountable?

- What monetary penalties or lawsuits from a governmental agency does a director potentially face?
- If the company were sold, could its directors be charged with fraudulent claims regarding the company's performance and future prospects?
- What about claims or charges brought by governmental agencies related to safety, environmental or employee issues?
- Do outside or independent directors bear unique responsibility or liability for claims from inside parties such as shareholders, or outside parties such as banks, insurance companies or governmental agencies?
- Does liability extend to a director or executive who approves compensation to a favored party who fails to provide service to the company to justify the payment?
- Do directors who serve on or as chairpersons of specific committees, particularly audit or compensation, face greater scrutiny, liability or responsibility for corporate actions and decisions?
- Must private company boards provide financial information to shareholders? On an annual basis? More often than annually? In what detail?
- Under what circumstances, if any, must private companies obtain audited financial statements?
- What obligation do private company boards have to fully disclose off-balance sheet financing, including loan guarantees, lease agreements, and contingent liabilities? What obligations exist to accurately report inventory write-downs or uncollectible receivables?

What are the Reasonable Standards of Care for Directors?

- What is a director's liability for membership and participation on a corporate board that may not be properly constituted or organized with formal committees, or which fails to include independent directors?
- What liability or obligation does a corporate director or executive have for participation on a board that fails to meet in accordance with the corporate charter and by-laws?
- Does liability for these directors exist if the corporation's board conducts business without a quorum present if it is required by the by-laws?
- Are corporate directors or executives liable if a board fails to analyze major policy decisions or provide reasonable oversight of company management? In such an atmosphere, could directors or executives also be charged with failure to execute their fiduciary responsibility to various corporate constituents? Even if such oversight and execution occurs, are directors liable if board minutes are not recorded or if they lack adequate detail of board activity?
- What is a director's liability or obligation in the absence of required board resolutions or approvals of major company decisions? Does such liability extend to lack of analysis or justification of major changes in strategy, capital expenditures, funding or management of deferred compensation plans, distributions to shareholders, executive compensation paid in any form, or decisions to hire or fire executives?
- Are directors who serve as members of the audit committee or compensation committee under greater risk if those committees could conduct independent meetings, but fail to do so?

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Valuation for M&A lays out the steps for measuring and managing value creation in nonpublicly traded entities, and helps investors, executives, and their advisors determine the optimum strategy to enhance both market value and strategic value and maximize return on investment. It provides a detailed guide for sellers and buyers to prepare for the sale and acquisition of a firm, spelling out how to identify, quantify, and qualify the synergies that increase value to strategic buyers.

Complete with a comprehensive case study to illustrate concepts and calculations, *Valuation for M&A* fills a gap that has long stymied both sides of the M&A equation, handing owners, managers, and strategic buyers the first effective methodology for measuring and building the value of a private company and ensuring that everyone gains the maximum benefit from the deals they make.

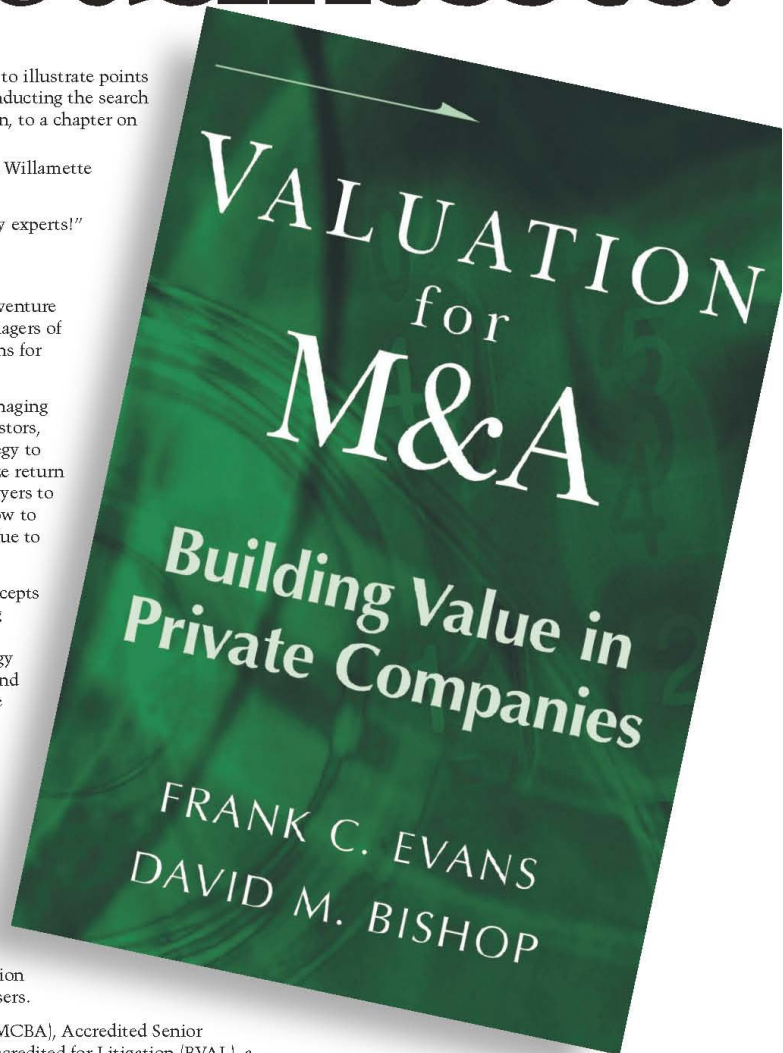
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- Can an audit committee in a company that lacks an internal audit function reduce its potential exposure by engaging outside internal audit services?
- Are directors who tolerate inaccurate or delinquent financial reports liable for failure to seek solutions?
- To what extent may directors rely, without liability, upon information, documentation and/or analysis provided by officers, employees, accountants, auditors or analysts?

What Protective Actions Could Affect Director Liability?

- Does the company qualify for directors' and officers' errors and omissions insurance?
- What indemnifications, if any, are specified in the corporate by-laws to protect directors and officers against claims or lawsuits?
- Do these indemnifications extend to heirs or estates? Do the indemnifications prohibit directors from engaging their own counsel? Do the indemnifications lapse if corporate insolvency occurs?
- What expenses are covered by the indemnification and what are excluded?
- Can directors who are covered by corporate indemnification and directors' and officers' insurance still be held personally liable for claims made against them by employees, customers, suppliers or competitors?

In today's more litigious environment, executives and directors must recognize their current and potentially expanding accountability and liability. Make sure that your corporate counsel keeps you adequately informed on these matters.

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Whether a strong-willed controlling shareholder will, in the end, actually share authority in the new corporate structure remains to be seen. At a minimum, other private companies are recognizing the need to conduct formal board meetings, prepare and execute agendas and authorize actions, and record adequately detailed minutes. Slowly emerging is the sense that some private company executives and directors believe that procedures that parallel Sarbanes-Oxley will improve the company's attractiveness to potential investors in the long-term.

Conclusion:

With the first year of the new Sarbanes-Oxley requirements behind public companies, the jury is clearly out on the advantages and disadvantages of the new legislation. For private companies, which are primarily exempt from the new regulations, the effect is even less well understood, but trends appear to be emerging. Private companies that must deal extensively with creditors, passive investors, regulatory agencies or publicly owned customers or suppliers will experience increasing pressure to enhance board operating formalities and accountability. In the process, however, is the opportunity for these companies to improve their strategic planning and return on investment through improved corporate governance.

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To systematically prepare for the future requires formal **strategic planning** to understand the company's competitive position – its strengths, weaknesses, opportunities and threats. Obviously, the strategic plan should drive the company's returns, risks, and value, as determined in Step One. Effective corporate governance requires this broad focus on the future.

Step Three: Identify and address your personal needs and goals.

Private company owners care deeply about their business - it's often a huge part of their lives. As a result, **personal issues**, relating to family, fellow owners, employees or customers, influence both key business decisions and how they are made.

To avoid making bad decisions, or more commonly, making no decision at all, owners must clarify critical business and personal issues that confuse or complicate their lives. This identifies areas of vulnerability in their decision process to enable solutions to difficult issues. Effective corporate governance includes a **leadership process** to resolve owners' personal needs and goals.

Step Four: Recognize key corporate stakeholders and their impact on corporate goals.

Every corporation has key people – owners, employees, family members – who can materially influence the company's performance and the owners' options. Individual shareholders may have very different investment goals that reflect their age, wealth, risk tolerance and career objectives. Essential employees may possess strengths or weaknesses that could materially

Outside Directors...Why?

The private company's CEO stressed, "A key reason we are private is to avoid needless oversight and reporting to external parties. It's our shareholders' business and they prefer to keep it private."

While privacy is a hallmark of our free enterprise system, accountability is a hallmark of successful companies. Independent outside directors - who are neither employees nor otherwise engaged by the company - can maintain privacy, while improving a company's performance and reducing its risk.

Key Outside Director Roles

Especially in companies accustomed to less formal governance, outside directors tend to contribute most in the following areas:

- Design and implementation of effective board management practices and governance policies.
- Provide a focus on management of the company as an investment to build shareholder value, and formulation of plans to ultimately harvest that value.
- Design and implementation of a process of accountability to third parties, including shareholders, creditors and governmental and regulatory agencies.
- Create a process for selection, evaluation and compensation of executive management.
- Develop procedures for establishment and implementation of an annual strategic planning process.

When Outside Directors are Needed Most

Seasoned, unbiased counsel is needed most in companies that must confront change, including:

- Introduction of new products, or entry into new markets or when encountering changing competitive conditions.
- Management of rapid growth.
- Implementation of executive management succession
- Planning for ownership transition to both maximize value and smooth the transition.

Outside Directors Really Mean Change

To sincerely and legitimately embrace use of outside directors is to abandon informal management - running the company as the owners choose on a day-to-day basis. It entails formal planning and reporting, formal board consideration and authorization of plans and budgets, and should create much tighter accountability by management. Outside directors bring knowledge, experience and independence to this process, and when used correctly, should help private company owners to build value.

affect corporate performance. These **key stakeholders** must be identified and their **needs** and **goals** assessed, to align their objectives with corporate goals so that these stakeholders and corporate owners can achieve business and personal success. Effective corporate governance requires continual management of stakeholders' needs and goals.

Conclusion:

Leadership Decisions

Executing steps one through four alone can be a minefield to private company owners as they face conflicting issues and

heavy demands from family members, stakeholders, and customers. For this reason, the 4Q Decision Assessment© was developed to guide private company owners through this process. It addresses each of the four critical areas - the 4Qs - that comprise the private company owners' unique challenges. The 4Q Decision Assessment© identifies issues that require attention, and provides the direction and leadership to achieve these goals. Effective corporate governance requires owners to possess a comprehensive insight into their unique private company investment. Call us to discuss how the 4Q process can give your company organization and direction.

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