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Small companies opt for tough rules

By ANNE FIELD
The New York Times

Even as some publicly traded small businesses are going private to escape the tough accounting standards stipulated by the 2002 Sarbanes-Oxley Act, a growing number of privately held companies are rushing to incorporate them, even though they do not have to.

These companies, which are exempt from the law's requirements, nevertheless see advantages in adopting them, as well as in instituting other corporate-governance changes like adding outside directors to their boards. Having witnessed the collapse of corporate giants like Enron, whose accounting malfeasance and weak management oversight inspired the legislation, these companies have a heightened appreciation of the need to strengthen their defenses against corruption, experts say.

They also know compliance with Sarbanes-Oxley is a precondition for going public, being acquired or raising money from venture capitalists.

"Sarbanes-Oxley has raised the visibility of these issues," said Jeff Westphal, president of Vertex, a tax software and services company in Berwyn, Pa.

It certainly has for Chris Winfield, president of 10E20, a Web-design start-up in Brooklyn. Winfield has spent the last few months searching for affordable software to help his company follow Sarbane-Oxley's accounting rules, even though it is privately held and had only $2 million in revenue last year.

Winfield has ambitious plans for growth, including an increase in the number of employees to 200 by 2006 from 28 today, and he wants to be ready to tap the stock market or put his company up for sale when the time comes. If he cannot find the right software program, he says, he will have his staff create one and integrate it with the company's accounting and back-office systems, a process that could take up to eight months.

"I think we have to get the ball rolling now," Winfield said. "It will definitely be worth the effort."

Sarbanes-Oxley created a regulatory board with broad powers to crack down on corporate accounting abuses, toughened corporate disclosure requirements, established protections for corporate whistle-blowers and required changes in the makeup of corporate boards.

Since its passage, a growing number of small publicly traded companies have announced plans to go private, in large part to escape the cost of compliance.

By the same token, the law has prompted many small companies to head in the opposite direction. According to Andrew Keyt, executive director of the Loyola University Chicago Family Business Center, more private companies are adding outsiders to their boards and introducing formal financial audit and compensation committees. They are also holding board meetings more often, he says, and taking a more critical look at the directors' performance.

In a 2003 survey by his organization of 3,000 mostly small businesses, 38 percent of boards met three or more times a year, up from 28 percent in a similar poll of 1,200 businesses in 1997, he said, while only 36 percent were satisfied with their board's contributions, down from 42 percent six years earlier.

Keyt believes the economic downturn, which many companies have only recently started to dig out from, has played a role in private companies' new corporate governance religion. "When business performance is down, shareholders are more concerned about the performance of the company," he said. "Corporate governance becomes more important."

Shane Pliska is a case in point. Pliska joined Planterra, his family's 30-year-old interior-landscape-design business in West Bloomfield, Mich., in 2003, two years after the company experienced a 20 percent decrease in sales. He decided to introduce more frequent and more formal board meetings partly because "the economic downturn made us look to how we could change things to make them better," he said. "When you're making a lot of money, you don't really think about that."

At the same time, since private companies are not beholden to the new law, they have more flexibility in making changes.

Craig Aronoff, a consultant with the Family Business Consulting Group in Marietta, Ga., says he is helping at least a half dozen small private companies set up boards of directors. The key, in many cases, is finding people with expertise in specific areas in which the businesses need help.

"You need a board that can show you how to grow the company," said Marc Morgenstern, managing partner with Kahn Kleinmen, a law firm in Cleveland. "Identify five or six skill sets, like sales or technology, find people who have them, and then let them challenge your assumptions."

Recruiting such talent takes persistence. Two years ago, Westphal of Vertex decided to look for outsiders to expand a board that consisted of his father, his mother, two sisters, his lawyer and himself. At an awards dinner one night, he spotted Richard Teerlink, the retired chairman of Harley-Davidson who is largely credited with turning its fortunes around through strong leadership and an emphasis on worker empowerment, and invited him to lunch. He arranged a second meeting a month later and persuaded Teerlink to act as unofficial consultant to his company. One year after that, Teerlink agreed to join the board.

"It's not something that can be done quickly or haphazardly," Westphal said.

At the same time, since private companies are not beholden to the new law, they have more flexibility in making changes. Pliska, for example, brought in the company accountant and lawyer to sit in on quarterly board meetings, but they appear as advisers, not board members. And his brother, who is not involved in the business, attends, to get a feel for operations "in case something happens to one of us," he said.

New is not always better, of course. Keyt recounts the experience of a family-owned manufacturing company that recently brought in several outside directors, only to find that they advocated an acquisition strategy that would have saddled the family with a high level of debt. Ultimately, two directors resigned and the family pursued a less risky growth strategy.

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In general, though, smart outsiders provide unexpected and valuable insights. Harry Seigle, chairman of Seigle's, a building-supply company in Elgin, Ill., with $240 million in annual revenues, reconstituted his board four years ago to include the heads of several similar companies operating in different regions of the country. Not long afterward, when his son wanted to leave his job as a high-school teacher to join the company, the board discussed what his role should be. Eventually, they suggested he use his technical skills as a teacher to help company employees learn how to operate a complex new software program. More recently, he moved into sales.

Similarly, Westphal of Vertex says his board has been instrumental in smoothing the transition from one generation of the family to the next.

Other good-governance procedures that have been embraced by corporate America are also trickling down to family-owned concerns.

In a recent survey of 100 small, privately held companies by Tatum Partners, an Atlanta firm that provides interim chief financial officers and chief information officers to companies, 58 percent said they were considering establishing a company code of ethics, also a requirement of Sarbanes-Oxley, and nearly 40 percent said they were weighing whistle-blower protection for employees.

Of course, the entrepreneurs who pay the most attention to such issues often have money on their minds. Small-business owners and consultants say acquisition-minded corporations and their underwriters look more favorably on target companies that conduct formal yearly audits, install professional boards of directors and institute good-governance policies than those that do not.

"It lowers the risk," said Douglass Tatum, a co-owner of Tatum Partners.

Jim Alterbaum, a New York lawyer who works with small businesses and who has noticed increased scrutiny of their corporate governance practices by potential buyers, encourages clients to take such steps as investigating loans made to company officers and directors and pushing the board "to get ahead of the curve."

"It's a competitive advantage," Alterbaum said.

It is not uncommon for venture capitalists to insist that companies they invest in take corporate governance seriously. Three such firms — Kodiak Venture Partners and North Bridge Venture Partners, both of Waltham, Mass., and Commonwealth Capital Ventures of Wellesley, Mass. — set several conditions before investing $12 million in Pragmatech, a technology company in Nashua, N.H., a year ago, according to its founder and chairman, Brooke Savage. They required Pragmatech to hire a new chief executive and chief financial officer, to create a formal board that meets every six weeks and to institute a more rigorous annual financial reporting process, he said.

"They expected us to act like a public company," Savage said.