

## **Positioning an IPO? Best Practices for Ensuring an Effective Ethics and Compliance Program**

### **Abstract**

An effective ethics and compliance program has an important role in any type of organization; however, should a company elect to issue an initial public offering (IPO), regulations, legislation, and policies become much more complex. With the passage of the Sarbanes-Oxley Act of 2002 (SOX), stringent new practices were put in place in an effort to emphasize accountability and integrity.

This white paper addresses how a company must prepare itself prior to issuing its IPO, specifically by implementing an ethics and compliance program and adhering to SOX best practices. The white paper defines the framework for an effective ethics and compliance program and the benefits of such a program. Without a program, the company cannot expect to garner success nor will it be in compliance with U.S. federal laws and regulations.

### **Introduction**

An era of quick offering IPOs occurred during the late 1990s dot-com craze. Companies went public and were soon flooded with capital. However, the bubble burst leaving many of these burgeoning companies bankrupt. Then the country was shocked by a series of financial scandals, leaving investors with no confidence in the market and the U.S. Congress with a mission to create a law with checks, balances, and consequences.

The answer was SOX, which has now become a significant part of any IPO. Even though there was a shortage of IPOs in the first six years since the dot-com bubble burst, the numbers are bouncing back, as there are still companies who need the opportunity to raise capital and grow their business<sup>1</sup>. The procedures, however, have become much more complicated.

To prepare for an IPO, a company must face many stringent regulations as part of SOX adherence including: providing accurate and timely financial data to investors, management accountability statements, document retention, whistleblower policy and procedures for handling complaints. In addition, there are other basic requirements established by the SEC,

amendments to the U.S. Sentencing Guidelines, and other elements that when established within a company can create an effective ethics and compliance program.

## **SOX Requirements**

Before positioning an IPO, a company must ready itself by implementing SOX requirements. A company does not have the luxury to take these regulations lightly. This is the law, and just because a company is financially sound does not necessarily mean it will go through the IPO process with no problems. SOX revolutionized the business landscape with these 10 provisions:

### **1. Document Retention Policy**

Per SOX, any person who alters, destroys, conceals, or falsifies any document or attempts to do so with intent to impede or manipulate an official proceeding, inquiry, or administration of any matter regarding a bankruptcy or federal investigation may be fined, imprisoned for up to 20 years, or both.<sup>2</sup> To prevent this from occurring, companies should execute a document retention policy that not only complies with SOX but all other applicable local, state, and federal laws. The obligation to preserve records occurs when it is reasonable to anticipate litigation or an investigation.

### **2. Whistleblower Policy and Procedures for Handling Complaints**

SOX requires that public companies not retaliate or discriminate against whistleblowers. Companies must also establish a procedure for the receipt, retention, and treatment of complaints concerning any misconduct, fraud, incidents, and other concerns, including anonymous, confidential reports from employees.

Best practices suggest an outsourced hotline rather than internal due to bias and fear from employees to report to an internal source. By utilizing a provider, the company can better monitor and document such reports with proprietary services.

Corporations have also found that employees should be given a way to submit these same types of concerns over the web, as some individuals are much more comfortable reporting issues over the web rather than by phone. Offering multiple methods enhances a company's ability to receive more information and ultimately prevent misconduct.

### **3. D&O Insurance**

Obtaining insurance in the post-Enron era requires much more work as underwriting standards have tightened, premiums have increased, and areas of coverage have been restricted.<sup>3</sup> A company must begin with evaluating its current policy and determine if its carrier offers any discounts for implementation of corporate governance standards. If not, then the smart choice is to shop around. Having a sound D&O policy is important in attracting and retaining quality board of director candidates.

#### **4. Related-Party Transactions**

SOX extended the related-party transaction rule, stating that the audit committee of a company should review and approve all related-party transactions, whereas prior to SOX the rule had been to review “where appropriate.” The best move for a company is to avoid related-party transactions; however, if this is not feasible then a review process should be implemented.

#### **5. Auditor Independence**

SOX strengthened the SEC’s standards regarding auditor independence such that non-audit services were prohibited, conflict-of-interest standards were bolstered, audit partner and second partner review became more stringent, and the relationship between the auditor and the audit committee was clarified and enhanced. Choosing the right auditor and monitoring that relationship closely are keys to keeping a company transparent.

#### **6. Director Independence**

A majority of a company’s directors must now be independent, with criteria based on that a director is not independent if he or she has, or has had within the last three years, a material relationship with the company (other than being a director). This change in policy has of course made independent directors harder to find. To prepare for IPO and SOX adherence, director scouting should begin far in advance of going public.

#### **7. Key Board Committees**

The most important committee is the audit committee, who as referenced above are an intricate part of policing a company’s financial transactions. The committee must consist of independent directors (minimum of three) who are financially literate, and at least one

member must have a certain level of financial sophistication<sup>4</sup>. There should also be formal oversight of executive compensation and director nominations.

#### **8. Prohibition of Personal Loans to Directors and Executive Officers**

SOX strictly prohibits public companies from extending or arranging a personal loan to its directors and executive officers. If this is a current practice in a company planning to pursue IPO, the prohibition does not become applicable until the company files its IPO registration statement; however, it is best to conclude this practice as soon as possible. If there are outstanding loans, they should be paid in full and terminated. A policy should be adopted disallowing these types of loans any further and should be communicated to those affected.

#### **9. Code of Ethics**

Public companies are now required to establish a code of ethics. Not only is this a guideline but also a way to set the appropriate tone and to effectively communicate what is and is not allowed. The code defines a company's rules, practices, and policies. With this straightforward document, no one at any level should be in doubt about the vision of the company.

In addition to the code of ethics, the U.S. Sentencing Guidelines also recommends a company adopt a compliance and ethics program to reduce and eliminate criminal conduct. The code is the beginning of this process, and should be carefully drafted, but should ideally be written in plain language so that all levels of employees will understand its important guidance.<sup>5</sup>

#### **10. Disclosure Controls and Internal Controls**

Section 404 of SOX addresses, specifically, internal controls. The section requires management to provide in the company's annual report an assessment of the effectiveness of the company's internal controls and the company's independent auditor to attest to that assessment<sup>6</sup>. Sections 302 and 906 further require CEOs and CFOs to certify as to their company's financials filed with the SEC<sup>7</sup>. Becoming truly transparent, which has become a response to SOX legislation, and instituting a system of internal controls is a long process that requires many checks and balances along the way. Starting this process well in advance of an IPO not only prepares a company to be a

public entity but also reassures prospective investors of a company's commitment to a culture of integrity.

### **Building a Framework for a Culture of Integrity**

In addition to the specific legislation in SOX and the U.S. Organizational Sentencing Guidelines, Global Compliance has identified seven more elements to help a prospective IPO be prepared for business as a public entity.

#### **1. Tone from the Top**

An organization's governing body must walk the walk. Beginning from those rules and good practices set forth in the Code of Conduct, it is imperative that executives and management clearly display and demonstrate those attitudes and behaviors. Without management "buy-in," other employees will not take a Code of Conduct or other compliance and ethics related policies seriously. Per SOX, chief executive officers and chief financial officers must sign off on the financial statements and evaluate internal controls. Therefore, they must be aware of the ethics and compliance program and its effectiveness. This level of accountability would have no significance if management does not incorporate ethics and compliance into their daily routine.

#### **2. Education and Training**

What good is an ethics and compliance program if employees are not continuously made aware of it? Awareness of a company's expectations is vital to creating an organization's culture of integrity. If it is engrained in employees' minds then it becomes second nature. Training on expected behaviors, legislation, and other policies also keeps employees involved and informed.

- 3. Outsourced Hotline (Anonymous):** Under SOX and the revised Guidelines, companies must employ an anonymous hotline that allows employees and other stakeholders to report misconduct, fraud, incidents and other concerns without fear of retribution. Moreover, it is important for companies using a hotline to effectively monitor and document follow-up action on such reports. This program should operate independent of management. This independence can be achieved through administration of the program by an independent third party to provide the intake mechanism.

An effective compliance program should also give employees a way to submit concerns over the web. Corporations have found that some employees are more comfortable reporting concerns over a web page than over the telephone. Supplying multiple methods for employees to report is an important component of a compliance program.

#### **4. Centralized Data Repository**

As the complement to a hotline and web reporting system, a centralized data repository to manage and assess the reporting of misconduct, fraud, incidents, and other concerns, is a must for any company serious about ethics and compliance. Employing a real-time data repository and retrieval system to house these reports keeps a company on track to better investigate allegations.

#### **5. Data Management System**

In addition to the hotline and web reporting system and centralized data repository, a company needs to have a system in place that provides a centralized database for documenting the actions taken as a result of allegations. A data management system tracks the investigation and resolution of allegations. This is another crucial tool in an effective ethics and compliance program.

#### **6. Investigation and Action**

Timely and accurate information received from the hotline and web reporting system, centralized data repository, and data management system make investigation and action much easier to manage. Integrating programs also maintains consistency.

#### **7. Ability to Query and Generate Reports**

With the Sox mandate of monitoring internal controls and auditing, companies who utilize a sophisticated case management system with query and report generation can more easily provide documentation of its efforts. This also allows companies to identify trends and conduct statistical analysis of the program's efficiency.

#### **8. Background Checks and Validation**

Instituting background checks on prospective employees allows companies a first line of defense. This practice helps establish hiring policies and procedures. Promoting these

types of checks and balances within a company demonstrates a further commitment to an ethical and compliant culture.

Validation, a method of self-assessment, is another way to prevent fraudulent behavior. Evaluating your current ethics and compliance program helps organizations target efforts more efficiently and economically. Evaluations should correlate directly to the primary drivers of a culture of integrity as cited under the U.S. Sentencing Guidelines as a matter of good business practice. Employee interview and surveys, document and process review, employee focus groups, and benchmarking are important validation tools.

Validation can identify areas for improvement within operations and employee performance. With these areas identified, corrective action such as training or operational modifications can cause positive change within a company.

### **Benefits of an Effective Ethics and Compliance Program**

Besides the obvious of adhering to regulations and laws and avoiding monetary penalties, an effective ethics and compliance program has numerous benefits that help to strengthen a company from the inside. In addition, a corporation can see the following added advantages:

#### **1. Prevention**

Prevent criminal acts and basic misconduct among employees by educating, communicating, and training. Less turnover and a more experienced staff yields a more efficient workplace.

#### **2. Reduced Exposure**

Reduce the exposure of board members, senior management and employees, and the company itself to criminal and civil liability. Benchmarking analysis and research by the General Counsel Roundtable found that each dollar of compliance spending saves organizations, on average, \$5.21 in heightened avoidance of legal liabilities, harm to the company's reputation, and lost productivity.<sup>8</sup>

#### **3. Reduced Costs**

Reduce costs related to litigation, fines, negative publicity, hiring processes, and overall workflow disruption from investigations and preventative policies.

#### **4. Enhanced Public Image**

A company positing an IPO has a huge transition to go to, specifically being seen as a public entity rather than private. Once a company goes public, its actions are reportable. By establishing an effective ethics and compliance program, a company is more likely to have a positive public image. The more transparent the company is the less speculation for fraudulent or questionable activities. From a marketing perspective, the boost in the company's credibility that accompanies such an image can be a valuable benefit.

#### **5. Increased Employee Retention**

With better hiring procedures, including background checks, a company makes a pledge to hire only those individuals with stellar professional experience. Continuing to educate, train, and communicate to employees only reinforces the company's commitment to its employees. Employees feel more confident about their employer and can be more engaged with their job. Employees also have no need to fear retaliation should they feel the need to report questionable activities.

### **Conclusion**

The preparation for an IPO is a long path for a company. The more it can do prior to an IPO the better. Imitating or revamping an ethics and compliance program is a clear way to demonstrate the company's best intentions. SOX has mandated many of the elements that drive an effective ethics and compliance program, including: hotline and web reporting and a Code of Conduct. A company that has sincere intent to become a public entity must now live under the rules of SOX, but a company does not have to be restrained by these obligations. Rather, a company learning to prosper under SOX has a much better chance of attracting shareholders and maintaining public interest.

A company can also employ additional elements that strengthen a company's ethics and compliance company. This practice further reduces risk and promotes the idea of transparency, which is regarded as a public company's best means of avoiding ethics and compliance violations.

The benefits of an effective ethics and compliance program surpass regulatory adherence and deterrence of fines. A company has the ability to create a thriving work environment with less

turnover, a positive image, and less money spent on investigations and litigation. That is money that can be better spent on company growth and employee benefits.

A comprehensive and integrated ethics and compliance program can seem complex and complicated; however, when established accurately with experience and expertise, it is one of the wisest investments a company can make in its future success as a public entity.

### **About Global Compliance**

Founded in 1981, Global Compliance provides products and services that create and maintain a business culture of ethical and compliant behavior. Their portfolio includes awareness and education products that reinforce an organization's values and educate on expected behaviors; information intake services that accommodate the reporting of allegations or incidents; online information management services to manage case investigations and analyze, chart, and report data to executive management; and field research services to evaluate and validate compliance with legislation, regulation, and organizational practices and procedures. Global Compliance provides customized solutions to public and private corporations, universities, colleges, government entities, and non-profit organizations, and currently serves one-half of America's Fortune 100 and one-third of America's Fortune 1000 corporations as well as many European- and Asian-based corporations. Global Compliance is headquartered in Charlotte, NC.

---

<sup>1</sup> Edward Cone, "Compliance: Is Sarbanes-Oxley Working?" June 12, 2006, [www.ciainsight.com](http://www.ciainsight.com)

<sup>2</sup> "Going Public? Top Ten Sarbanes-Oxley Best Practices You Should Implement," December 22, 2005, [www.bipc.com](http://www.bipc.com).

<sup>3</sup> Ibid.

<sup>4</sup> Ibid.

<sup>5</sup> USSG Section 8B2.1.

<sup>6</sup> Sarbanes-Oxley Act of 2002

<sup>7</sup> Ibid.

<sup>8</sup> Integrity Driven Performance by PriceWaterhouseCoopers.