

# SARBANES-OXLEY ACT: FOR ONE-THIRD OF THE SMALLEST US PUBLIC COMPANIES ... 'THE JIG IS UP'

**O**EM Capital believes the stock tables will get a lot smaller. We expect the increased costs of complying with the new Sarbanes-Oxley Act will just be too high for many. As a result, one-third of US public companies will either liquidate or be sold, merged or taken private in the next few years.

Approximately one-third of all US public companies, have a market capitalization (share price multiplied by the number of shares outstanding) *under* US\$10 million.<sup>1</sup> We call them *nanocap* companies. This list comprises almost 3,000 US companies.

Historically, the cost of being a nanocap public company, if it files quarterly reports with the US Securities and Exchange Commission (SEC) and provides its shareholders with timely communication, has been estimated at approximately US\$300,000 annually. We estimate that complying with the Sarbanes-Oxley Act will cost these nanocap companies an *additional* US\$300,000 to 500,000 annually. This will bring their total annual cost of remaining a

public company to between US\$500,000 and 800,000 a year.

The cost for these nanocap companies remaining public will, therefore, be very high. To see how high, we only need to do a quick calculation.

If we assume these 3,000 or so companies are all profitable, a combined federal and state income tax rate of 40%, and average annual revenues of US\$10 million, the cost is approximately 4% of revenues using the mid-point of our estimate. If the shares of such companies average a price-to-earnings ratio of 10, we would eliminate approximately US\$4 million of market capitalization for each of these 3,000 companies. This could add up to US\$12 billion of lost shareholder value if all our 3,000 companies had the same profile.

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<sup>1</sup> Multex.com, Inc. as of January 10, 2003

However, there is a silver lining for outside shareholders. We also expect a substantial compensation impact to those CEOs who are also major shareholders that run 'their' public company as a lifestyle business and/or take compensation that could be judged excessive by a truly independent board of directors. For those CEOs who opt to keep their companies public rather than sell, merge or take them private, the new law should prod them to take actions to maximize shareholder value, or at the very least, to offset some of the increased corporate expenses as a result of the law by having their compensation reduced closer to market value.

Set forth below are the highlights of the new law.

## **SARBANES-OXLEY HIGHLIGHTS<sup>2</sup>**

- Creates Public Company Accounting Oversight Board.
- Prohibits outside auditor from doing non-audit services, such as management consulting, for the client.
- Makes the audit committee responsible for appointing and overseeing the outside auditor.
- Requires more independent directors on the audit committee.
- Requires CEOs and CFOs to certify company financial statements.
- Establishes criminal liability for failure of corporate officers to certify the company's financial reports, with penalties of up to 20 years in jail and US\$5 million in fines for willfully certifying a statement knowing that it does not comport with the Act.
- Requires CEO and CFO to forfeit certain bonuses and compensation following an accounting restatement that has been triggered by a violation of securities laws.
- Prohibits insider trades during pension fund blackout periods.

- Directs the SEC to issue rules of professional responsibility for attorneys who practice before the commission.
- Requires disclosure of all off-balance sheet transactions and relationships that may have a material effect on financials.
- Requires pro-forma numbers to be presented in a manner that is not misleading.
- Prohibits personal loans to executives and directors.
- Requires executives and principal stockholders to report changes in securities ownership within two business days.

Set forth below are the major reasons why the annual costs of being a public company could be as much as three times what nanocap companies are now spending. They fall into five categories: increased internal accounting expenses; greater attorney, director and audit fees; and higher insurance costs.

## **LIKELY ADDITIONAL EXPENSES TO COMPLY WITH THE ACT**

- The company, most likely, will require additional staff to track the information requirements of the Act and to prepare the additional government compliance documentation.
- The company may need to hire a stronger CFO to assure the CEO and directors that the requirements of the Act are being satisfied.
- CEOs and CFOs will often seek outside counsel, paid for by the company, prior to certifying company financial reports.
- Corporate attorneys will be billing more for increased time advising on compliance issues and reviewing the company's compliance documentation.
- More independent directors may be needed and their increased risk exposure will drive up their fees and expenses, particularly attorney fees, which will be reimbursed to them by the company.

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<sup>2</sup> Thomas, *Electronic Business*.

- Also driving up directors' fees will be their increased responsibility and more of their time spent on longer board meetings, executive sessions, committee meetings, telephonic contact with other directors and the company officers, as well as more extensive outside research and meeting preparation.
- Increased payments for a non-executive chairman or lead director.
- There may be higher director turnover and, as a result, higher recruiting fees.
- Outside auditors will be raising fees for the additional work to meet the higher standards of compliance.
- Outside auditors, without the ability to also provide non-auditing services, may increase hourly charges as well.
- Insurance companies will increase their premiums for issuing directors and officers insurance.
- The company may need to self-fund some of its liability exposure resulting from more narrowly written insurance coverage.

### ***Critical Decisions Are Looming for CEOs and Directors of Nanocap Public Companies***

Whenever there is a 'sea change', as the Sarbanes-Oxley Act, the advantage goes to those companies who are first to act. For CEOs of nanocap companies, they need to assess their appetite and ability to either grow by merging with other nanocap companies or being the 'first mover' to put their company up for sale. Although many CEOs who may not have a large ownership stake in such companies may be reluctant to make themselves redundant, independent directors will be very remiss in their fiduciary responsibility to shareholders by not taking appropriate action.



**Ronald J. Klammer** is a managing director and president of OEM Capital Corp. (DE). In 1985 he co-founded its predecessor firm, a New York partnership, where he led its technology practice. He has over 35 years of experience in all aspects of the electronics industry.

Previously, Mr. Klammer was a corporate vice president of Gulton Industries, Inc., a diversified NYSE electronics company, where he was responsible for initiating and closing the acquisition and divestiture of six businesses and returning four divisions to profitable growth. Prior to this, Mr. Klammer was vice president of Cross River Products, Inc., a venture-capital-backed manufacturer of consumer products. Earlier, he held various management and technical positions with General Electric's Missile and Space Business Group with a specialty in communication, control and computer systems.

Mr. Klammer holds a Bachelor of Electrical Engineering degree from Villanova University, a Master of Science degree from the University of Pennsylvania and a Master of Business Administration degree with distinction from Harvard University's Graduate School of Business Administration.

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## **COMMENTARY**

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Since 1985, the firm has initiated and completed numerous transactions for New York Stock Exchange listed, American Stock Exchange listed, NASDAQ listed, and a variety of over-the-counter and privately held companies located throughout the United States. Typically, the companies, subsidiaries or divisions we are asked to help have annual revenues between US\$10 and 50 million. Where we have been financial advisors in the sale of a division or subsidiary, some of our clients have had annual revenues in excess of US\$2 billion.

The firm has been able to realize exceptional results because its senior staff is comprised of professionals who have had extensive prior experience as operating executives in the industry and continue to

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