Hale and Dorr LLP
2002/venturecapitalreport

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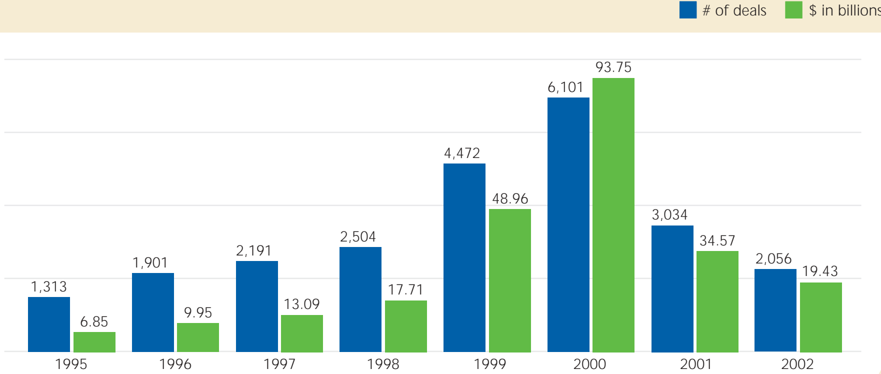


The downturn in the U.S. venture capital financing market that characterized 2001 continued during 2002. The total number of venture capital financings decreased from 3,034 in 2001 to 2,056 in 2002. The total amount invested in venture capital financings experienced an even greater decline, dropping from $34.6 billion in 2001 to $19.4 billion in 2002. Both the 2001 and 2002 figures represent a dramatic decline from 2000, when there were a staggering 6,101 venture capital financings, raising a total of $93.8 billion.

To put 2002 in perspective, however, one must look back before the "bubble" years of 1999-2000 and compare 2002 to 1995-1998. As illustrated by the chart to the right, the number of venture capital financings in 2002 was comparable to the number of annual deals in the years 1995-1998, and the amount invested in 2002 actually exceeded the amount invested in each of these years.

Valuations of venture-backed companies have shown a similar pattern. The median pre-money valuation for companies raising venture capital money in 2002 (through the third quarter) was $10.5 million, as compared to $15.2 million in 2001. While this is strikingly lower than the median pre-money valuation of $24.5 million in 2000, it is comparable to the median valuations in 1996 ($11.0 million) and 1997 ($13.0 million).

Seed and first round financings continued to decline in 2002 as a percentage of all venture capital investing. Seed and first round financings ranged from 48% to 50% of total venture financings in each year between 1995 and 1998. This percentage increased to 54% in 1999 and 55% in 2000, as the number of start-ups being funded rose substantially. However, the number of seed and first round financings dropped to 37% of total financings in 2001 and 30% of total financings in 2002 as many venture capitalists shifted their focus to existing portfolio companies.

While the number and valuation of venture capital financings have vacillated significantly over the past few years, venture capital investing by industry has been more stable during this period. Financings of information technology companies represented between 54% and 59% of total venture capital financings in each year between 1995 and 2002. Moreover, within the information technology sector, software was the most active market segment in each year between 1995 and 2002, with the number of financings by software companies typically doubling the number by communications and networking companies—the next most active market segment.

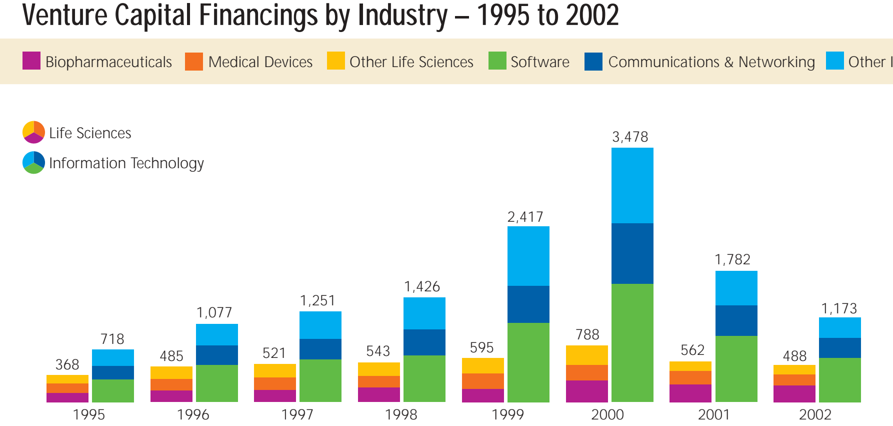
Financings in the life sciences sector trended down from 28% of all venture capital financings in 1995 to 13% in both 1999 and 2000—the height of the Internet frenzy—even as the total number of financings of life sciences companies increased from 368 in 1995 to 788 in 2000. This trend has reversed itself more recently, as financings of life sciences companies as a percentage of all venture capital financings rebounded to 24% in 2002.

The geographic regions receiving venture capital funding have remained remarkably consistent over the 1995-2002 period. In every one of those years, the top-ranked state—based on the number of in-state companies raising venture capital money that year—was California, by a wide margin, representing 41% of the total number of venture capital financings during this period. Massachusetts ranked second in each of those eight years, also by a comfortable margin, representing 11% of the total number of venture capital financings during this period. The third-ranked state in each of those years was either New York or Texas.

While the number and valuation of venture capital financings in 2001 and 2002 were down significantly from the 1999-2000 levels, liquidity events for venture-backed companies declined even more sharply. IPOs by venture-backed companies dropped from 248 in 1999 and 200 in 2000 to 21 in 2001 and 19 in 2002. These figures are also dramatically lower than the number of venture-backed IPOs during the 1995-1998 period, when there was an average of 137 per year.

M&A activity shows a similar, although less precipitous, decline. The number of acquisitions of venture-backed companies dropped from 449 in 2000 to 387 in 2001 and to 325 in 2002. Despite this decline, the number of acquisitions in 2001 and 2002 was not significantly lower than in 2000, was comparable to the 1999 number (302) and was greater than the average number in 1995-1998 (202). However, there has been a startling decrease in the purchase prices for those acquisitions. The average price paid for a venture-backed company during 1995-1998 was $76.9 million. During 1999-2000, this figure rose to $192.2 million. The average acquisition price for a venture-backed company declined to $55.4 million in 2001 and it declined further to $29.8 million in 2002. These M&A trends are illustrated in the charts on pages 8 and 9.

Given that the Internet-driven investment frenzy during 1999-2000 was an anomaly that is unlikely to recur, the decline in venture capital investments and valuations during the last two years, to levels commensurate with those in the 1995-1998 timeframe, is neither surprising nor alarming. However, the fall-off in liquidity events for venture-backed companies from 1995-1998 levels is considerably greater, and cannot be viewed with the same equanimity. ■



Despite the negative trends in 2002 for many venture capital financing statistics, the general consensus of the venture capital community seems to be that the market will improve during 2003. We believe it is reasonable to expect that both the number of venture capital financings and the total amount invested in those financings will show some increase over 2002, for several reasons:

- The U.S. economy appears to be improving, albeit slowly, and there is optimism that this gradual improvement will continue through 2003, thus enhancing the prospects of success for venture-backed companies and making them a more attractive investment.
- Many companies have significantly reduced spending on technology over the past two years, and these companies will likely have to increase technology spending in the near future, irrespective of the economy, in order to prevent their information technology systems from becoming a competitive disadvantage.
- Venture capitalists have been focusing a significant portion of their time during the past two years on struggling portfolio companies, many of which have been shut down or sold. While many more portfolio companies will certainly come to unhappy ends in 2003, there is a general consensus that venture capitalists will be spending less time in 2003 tending to struggling companies and will have more time to focus on new investments.
- Venture capital funds currently have a tremendous amount of capital to invest, as well as economic incentives to invest it.

Whether valuations of venture-backed companies will improve in 2003 is more uncertain. One school of thought holds that the valuations in 2002 have sunk so low that they *must* have reached bottom, and it is therefore reasonable to expect some increase in valuations in 2003. On the other hand, unless the IPO and M&A markets improve to the point where investors have a legitimate expectation for liquidity at reasonable valuations, venture capitalists will be able to realize acceptable returns on their investments only by investing at the depressed valuations that characterized the 2002 market.

We expect that many companies will continue to have difficulty raising money in second and later rounds in 2003, for several reasons:

- Potential investors may fear that companies with high cash-burn rates will need additional, and potentially very dilutive, financing before reaching cash flow breakeven.
- Companies that have already raised a large amount of venture money—which is true of many companies that did financings in the 2000 time frame—may find it difficult to attract new investors because of the large liquidation preferences that already exist. New investors often insist on a senior liquidation preference and/or a multiple liquidation preference. Even if existing investors are willing to agree to this, the result may be that the total liquidation preference that must be paid before management and employees receive any payout greatly exceeds the value of the company, which makes it difficult to retain and motivate key employees.

As a result, later round financings, even at low valuations, may be unattractive to new investors and may require complicated recapitalizations of the company that are difficult to negotiate and implement.

Many market observers believe that a greater proportion of venture capital dollars will be invested in new companies in 2003. Among the factors that could lead to increased funding of start-ups are:

- investors spending less time on troubled portfolio companies and more time looking for new investments;
- the relative unattractiveness, as discussed above, of many later-stage investment opportunities; and
- the fact that some of the characteristics of a poor economy—for example, the availability of talented people, lower salaries and lower real estate costs—make it relatively more attractive to invest in a start-up company.

Venture capitalists are placing more and more emphasis on a company's ability to demonstrate customer "traction"—either through early revenue or customer validation of the company's product or product concept—before investing. As a result, we believe it is likely that 2003 will see an increase in the number of companies that temporarily fund their operations through sources other than traditional venture financing before approaching venture capitalists. Techniques will include small seed rounds from early stage investors and "bootstrapping" through friends-and-family investments and small amounts of revenue at an early stage.

It is harder to predict which market sectors will be attractive to venture capitalists in 2003. We expect that venture capitalists will continue to be very selective in the telecom and networking sectors. There seems to be more optimism surrounding the software segment, particularly security, storage and enterprise software. Software companies appear relatively more attractive, both because there is optimism that businesses will increase software spending before they increase purchases of hardware and equipment, which tend to be more expensive, and because software companies generally need less cash to fund their operations and are therefore perceived as less risky. ■

January 2003

Public companies are facing dramatic changes in disclosure and corporate governance requirements under the Sarbanes-Oxley Act of 2002 and new or proposed rules from the SEC, NASDAQ and the NYSE. While these new rules and regulations do not generally cover private companies, they do affect private companies:

- A private company will become subject to the Sarbanes-Oxley Act upon filing a registration statement with the SEC in anticipation of an IPO.
- Certain aspects of the Sarbanes-Oxley Act may indirectly become applicable to a private company if it is acquired by a public company.
- The boards of directors and management of many private companies are embracing various aspects of the Sarbanes-Oxley Act as "best practices."

Summarized below are the new requirements that are most likely to be relevant to private companies. Familiarity with these new rules will help private companies avoid pitfalls that could interfere with important future milestones, such as an IPO or acquisition, and help establish a culture of fiscal and corporate responsibility.

Prohibition on Personal Loans

The Sarbanes-Oxley Act prohibits public companies and companies that have filed an IPO registration statement (even if not yet effective) from extending, maintaining, renewing or arranging personal loans to directors or executive officers. Loans that existed on July 29, 2002 are permitted to remain outstanding, so long as they are not materially modified or amended. Upon the filing of an IPO registration statement, all outstanding loans made after July 29, 2002 to a person who is a director or executive officer of the company at the time of filing will be illegal.

Private companies should consider prohibiting all officer and director loans or requiring that any loans made or modified after July 29, 2002 be repaid immediately prior to the filing of an IPO registration statement if at that time the borrower is a director or executive officer of the company. Private companies should also consider requiring repayment if the company is acquired by a public company and the borrower becomes a director or executive officer of the acquirer.

However, private companies should bear in mind that repayment prior to the filing of an IPO registration statement, or an acquisition, may not be practical since there will not yet be a public market for the company's stock, and forgiveness of such loans may result in unfavorable accounting treatment.

Stockholder Approval for Stock Plans

The NYSE has proposed changing its rules so that brokers holding stock of a public company in "street name" may vote those shares in favor of proposals to adopt a new employee stock plan or to increase the number of shares covered by an existing plan only if explicit voting instructions are received from the underlying beneficial owner. This change would affect all public companies, since it would apply to voting by all brokers that are members of the NYSE, regardless of where the shares being voted are listed.

This rule change may make it significantly more difficult for public companies to obtain stockholder approval of stock plans. This underscores the need for a company contemplating an IPO to evaluate whether it needs to increase the number of shares covered by its employee stock option plan and whether it wishes to adopt any new stock plans—such as a director stock option plan or an employee stock purchase plan—while it is still a private company and stockholder approval is easier to obtain.

Board of Directors and Board Committees

Private companies should be prepared to comply with the new rules relating to the composition of a board of directors and board committees prior to filing an IPO registration statement:

- ***Board Independence.*** Proposed NASDAQ and NYSE rules require that a majority of the directors be "independent," although the proposed definition of "independent" varies between the two exchanges.
- ***Audit Committees.*** The Sarbanes-Oxley Act and stock exchange rules impose heightened requirements for audit committee composition and impose additional responsibilities on the committee:
  - **Independence.** All members of the audit committee must be "independent." Of note is a proposed NASDAQ rule that would prevent 20% stockholders from being considered independent, which may disqualify some of a company's venture capitalist directors from serving on the audit committee. A proposed SEC rule would provide that persons owning less than 10% of a company's stock would not be precluded from being considered independent for audit committee purposes by virtue of their stock ownership.
  - **Financial Expertise.** The Sarbanes-Oxley Act requires companies to disclose in their Form 10-Ks whether the audit committee has at least one "audit committee financial expert;" the SEC's definition of "audit committee financial expert" requires that the person have specified accounting expertise that is generally acquired either through experience as an accountant or as CFO or controller or through experience supervising such a person.
  - **Responsibilities.** The audit committee has the direct and sole responsibility for the appointment, compensation and oversight of the company's auditors. The audit committee is also responsible for pre-approving audit services and any permitted non-audit services.
  - **Accounting Complaints.** The Sarbanes-Oxley Act requires the audit committee to adopt and implement procedures for receiving and handling complaints regarding accounting matters, including the confidential and anonymous submission of employee concerns regarding accounting matters.
- ***Compensation Committees.*** Both NASDAQ and the NYSE have proposed that compensation committees must consist solely of independent directors.

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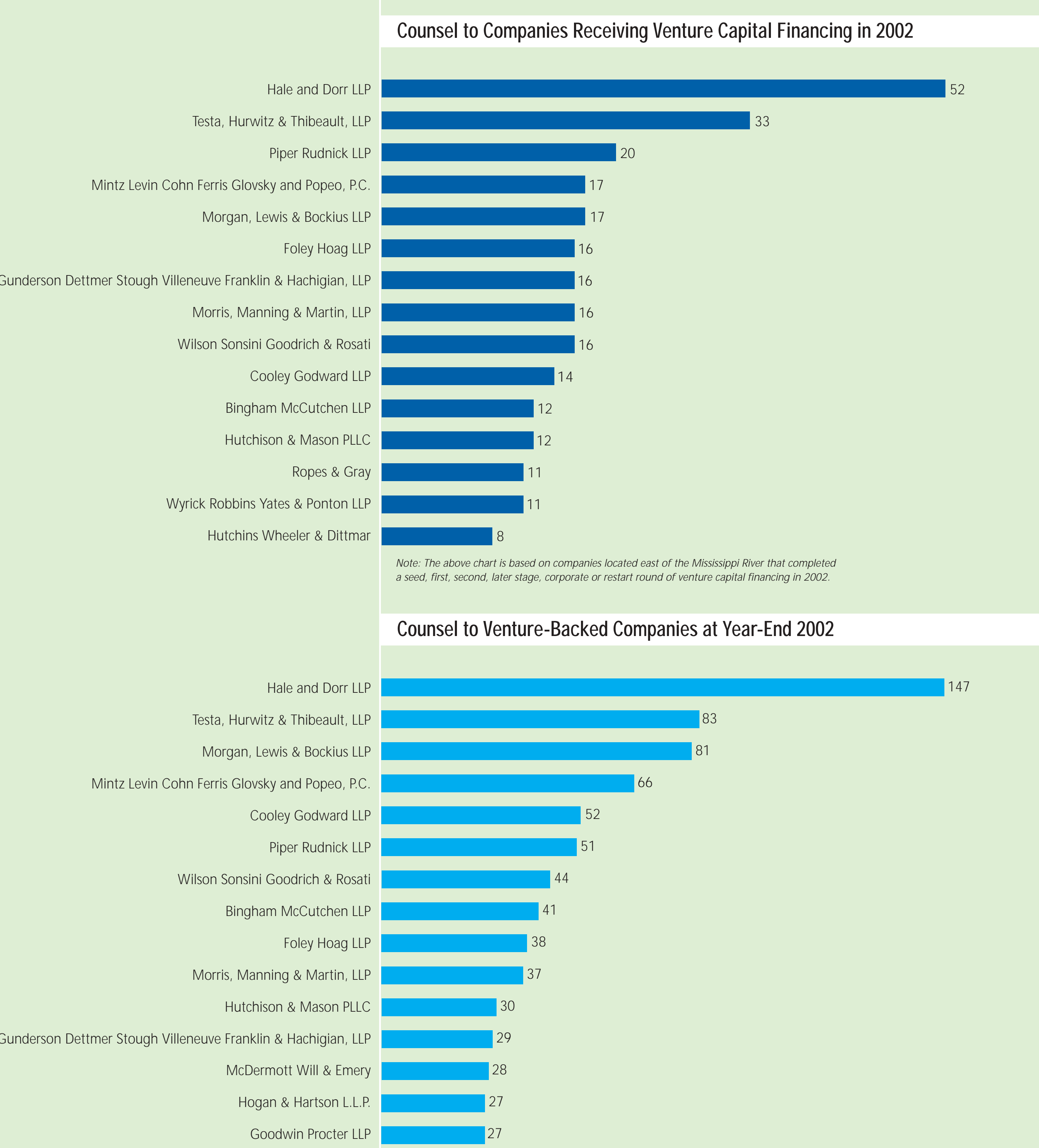


Note: The above chart is based on companies located east of the Mississippi River that completed a seed, first, second, later stage, corporate or restart round of venture capital financing in 2002.

Note: The above chart is based on companies located east of the Mississippi River that completed a seed, first, second, later stage, corporate or restart round of venture capital financing and were private and independent as of the end of 2002.

$22,000,000
Second Round
March 2002

$26,000,000
Second Round
May 2002

$26,000,000
Third Round
March 2002

$25,000,000
Second Round
January 2002

$14,000,000
First Round
March 2002

Surface Logix

$25,000,000
Third Round
March 2002

$35,800,000
Second Round
February 2002

$40,000,000
Third Round
March 2002

$70,000,000
Second Round
June 2002

$10,000,000
First Round
October 2002

$10,500,000
First Round
January 2002

$15,500,000
First Round
March 2002

$40,000,000
Third Round
February 2002

endius

$8,100,000
Third Round
May 2002

RELICORE

$14,000,000
Second Round
September 2002

IE-ENGINE INC.

$6,400,000
Second Round
October 2002

HYDRA BIOSCIENCES

$9,300,000
First Round
April 2002

FLEXPLAY

$5,000,000
Third Round
March 2002

$7,700,000
First Round
May 2002

NETEZZA

$20,000,000
Second Round
January 2002

$16,000,000
Late Stage
December 2002

$3,500,000
Bridge Round
July 2002

$10,600,000
First Round
July 2002

$2,000,000
Seed Financing
February 2002

$7,000,000
Third Round
September 2002

$4,500,000
Second Round
April 2002

STORABILITY SOFTWARE

$12,000,000
Third Round
June 2002

upromise

$12,000,000
Third Round
September 2002

$37,000,000
Third Round
April 2002

$3,200,000
First Round
October 2002

$17,000,000
Fourth Round
January 2002

Princeton eCom

$10,000,000
Late Stage
June 2002

Tatara SYSTEMS

$8,500,000
First Round
July 2002

netDecide

$6,500,000
Fourth Round
September 2002

Undisclosed
Third Round
February 2002

$4,000,000
Fourth Round
December 2002

$7,750,000
Third Round
August 2002

SRA INTERNATIONAL, INC.

$39,600,000
Mezzanine Round
April 2002

Hale and Dorr > >> the leader in technology and life sciences company venture financings.

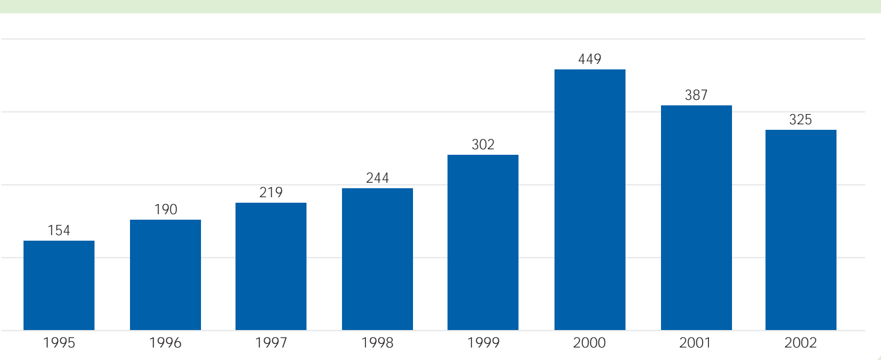
The sale of a portfolio company is one of the two primary routes for a venture capitalist to obtain liquidity for its investments. There are several key points a venture capitalist—particularly one with a representative serving on the company's Board of Directors—should keep in mind when considering an acquisition proposal for a portfolio company.

Allocation of Deal Consideration

Acquiring companies often propose an acquisition price without specifying how this will be allocated among the various classes of equityholders of the target company. Among the issues that venture capitalists should understand and consider are:

- Will the deal consideration be allocated strictly in accordance with the liquidation preferences of the outstanding preferred stock set forth in the target company's charter? If either the acquiring company or the target company desires that the allocation vary from that mandated by the charter—such as providing more to the holders of common stock—it will generally be necessary to amend the charter or obtain a waiver of rights under it. This raises issues with respect to:
  - The stockholder vote required to approve such an amendment or waiver, which may require the consent of only the holders of the affected class or series of stock, the holders of all preferred stock voting as a single class, the holders of all outstanding stock, or a combination of these consents.
  - The fiduciary duties of the target company's Board of Directors. Recommending a charter amendment or waiver that would result in one class of stockholders obtaining a smaller portion of the acquisition price than they would otherwise be entitled to under the charter could subject the Board to claims by the affected class of stockholders, absent a valid business justification for such amendment or waiver.

Acquisitions of Venture-Backed Companies – 1995 to 2002



- How do outstanding stock options and restricted stock affect this allocation?
  - In a stock-for-stock merger, the outstanding stock options of the target company generally roll over into options for stock of the acquiring company. Does the acquisition price proposed by the acquiring company include the number or value of the acquirer shares that will be subject to these assumed options (thus reducing the shares available to stockholders of the target company), or will any shares subject to assumed options be added to the number or value of the shares comprising the proposed purchase price?
  - A significant portion of the restricted stock and stock options of the target company will likely be unvested, and some outstanding options may be out-of-the-money at the proposed acquisition price. Should unvested stock and options and out-of-the-money options be taken into account in converting the aggregate purchase price to be paid by the acquiring company into the price per share of target company stock?

Registration of Acquiring Company Shares

If the acquiring company issues its common stock in payment of the purchase price, the target company stockholders generally cannot sell those shares unless they are first registered under the Securities Act of 1933. This registration typically occurs in one of two ways:

- the acquiring company issues unregistered shares, but agrees to register them, usually on a resale Form S-3 registration statement, within a short period of time following the closing (this alternative is generally possible only if there are 35 or fewer target company stockholders that do not qualify as "accredited investors"); or
- the acquiring company registers the shares on a Form S-4 registration statement before issuing them at the closing.

Receiving unregistered shares accompanied by resale registration rights has several advantages:

- The transaction can be closed more quickly—sometimes by a matter of several months—since no pre-closing SEC filings are required.
- If the investor's fund is an affiliate of the target company—which will usually be the case if it has a representative on the Board—the fund may publicly sell acquiring company shares which have been registered on a Form S-4 only in compliance with the volume and other restrictions imposed by Rule 145 under the Securities Act. These restrictions are not applicable if the fund (or its partners) is selling the shares pursuant to a resale Form S-3 registration statement.

However, this approach also has several disadvantages:

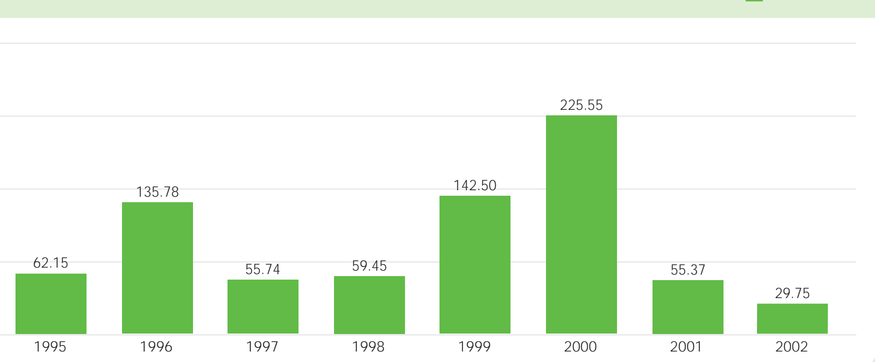
- The former stockholders of the target company cannot sell the acquiring company shares in the public market until the Form S-3 registration statement has been filed with, and declared effective by, the SEC. While a Form S-3 can often be filed and declared effective within only a week or so after the closing, there are a number of factors that could delay the filing or effectiveness of the Form S-3.
- The resale registration rights negotiated as part of the acquisition agreement may not require the acquiring company to register all of the shares issued in the acquisition immediately, or may permit the acquiring company to terminate or suspend the registration in some circumstances.
- If the Form S-3 contains a material misstatement or omission, a former target company stockholder that sells shares under the Form S-3 could have liability, under Section 12 of the Securities Act, to the purchaser of those shares. This risk of liability is not applicable to the sale of shares registered on a Form S-4.

Fiduciary Duties of Directors

The actions of directors in connection with a sale of the target company are often, although not always, subject to enhanced legal scrutiny. It is important for directors to consult with counsel to understand the legal standards applicable to a particular transaction and the steps they should take to fulfill their fiduciary duties under those standards. Target company directors should:

- Disclose to the other Board members any potential conflicts of interest they or their fund may have with respect to the transaction, such as an investment in or affiliation with the acquiring company.
- Consider engaging an investment banker to assist in soliciting other acquisition proposals, to help value the securities of the acquiring company to be issued in the acquisition and/or to provide a "fairness opinion" on the transaction.
- Stay informed regarding transaction discussions and provide input on the negotiation of key deal terms.

Average Acquisition Price for Venture-Backed Companies – 1995 to 2002



Voting Commitments from Target Stockholders

The fiduciary duties of a target company's Board of Directors generally require the company to do one of the following to ascertain whether a better value for stockholders of the target company could be obtained from another acquirer:

- contact potential acquirers before signing an acquisition agreement; or
- preserve in the acquisition agreement the ability to accept a superior proposal from another bidder, either by permitting the target company to terminate the agreement if it receives a superior acquisition proposal or by ensuring that the target company's stockholders have the capability of voting against the first transaction.

If the acquiring company has obtained voting commitments from stockholders of the target company holding a sufficient number of shares to guarantee stockholder approval of the acquisition—thus effectively precluding the Board from considering superior proposals—the approval of that transaction by the target company's Board may be a violation of the Board's fiduciary duties, unless the target company has conducted a thorough "market check" before signing the acquisition agreement.

Section 280G Issues

Section 280G of the Internal Revenue Code imposes on senior executives a 20% excise tax (in addition to normal income or capital gains tax) on compensation—including the value of accelerated stock options or restricted stock—that is contingent upon a change in control of the company, if such compensation is in excess of a specified level. In addition, the compensation subject to that excise tax is not deductible by the company. Depending upon the facts and circumstances involved, there may be ways for the target company to avoid the imposition of these tax provisions, which would help out both the acquiring company (which will assume responsibility for the tax obligations of the target company) and the affected executives.

Limitations on Liability

While the negotiation of the details of the acquisition agreement is generally handled by company management and counsel, venture capitalists should ensure that the following provisions are included in the agreement if at all possible:

- The indemnification obligations of the target company stockholders to the acquiring company should generally be limited to the portion of the purchase price placed in escrow to secure the indemnities.
- The acquiring company should agree to maintain both (1) the target company's charter or by-law provisions regarding indemnification of the persons serving as directors or officers of the target company before the acquisition and (2) the target company's existing D&O insurance following the closing (generally for six years). ■

New England

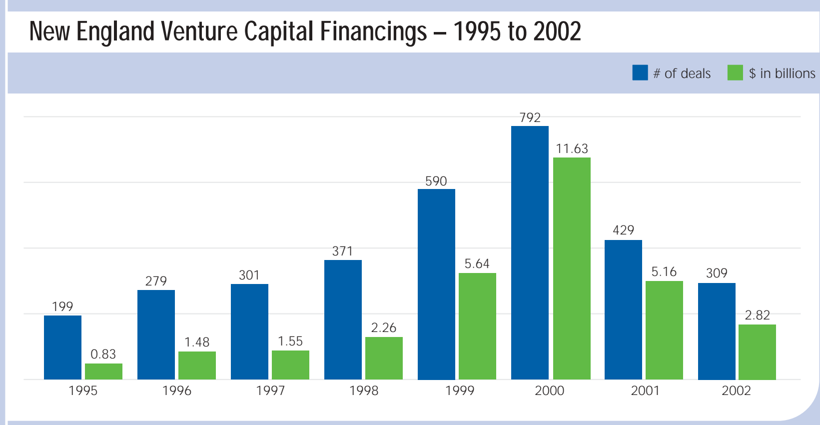
In 2002, there were 309 venture capital financings in New England, a decrease of 28% from the 429 in 2001. The total amount invested in New England fell by 45% from $5.16 billion in 2001 to $2.82 billion in 2002. New England continued to produce a higher proportion of biopharmaceutical financings than the national average, reflecting the growth of Massachusetts as a leading center of life sciences activity. While venture capital investments in 2001 and 2002 were far short of the 2000 peak, when 792 venture capital financings raised $11.63 billion, 2002 activity remained well above the average for the 1995-1998 period of 287 financings raising $1.53 billion.

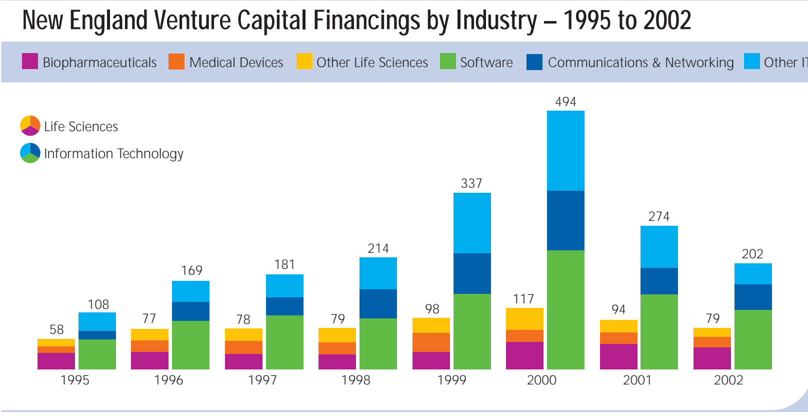
For 2003, we expect New England—and especially Massachusetts—to remain a very attractive region for venture capital investments for several reasons. First, the large number of world-renowned colleges and universities will continue to produce exciting technological innovations and a talented employee pool. Second, the numerous existing established high technology and life sciences companies will continue to spawn entrepreneurs and ideas for founding new companies. Third, the existing network of venture capitalists and other service providers focused on serving venture-backed companies makes the region an appealing place to start a company.

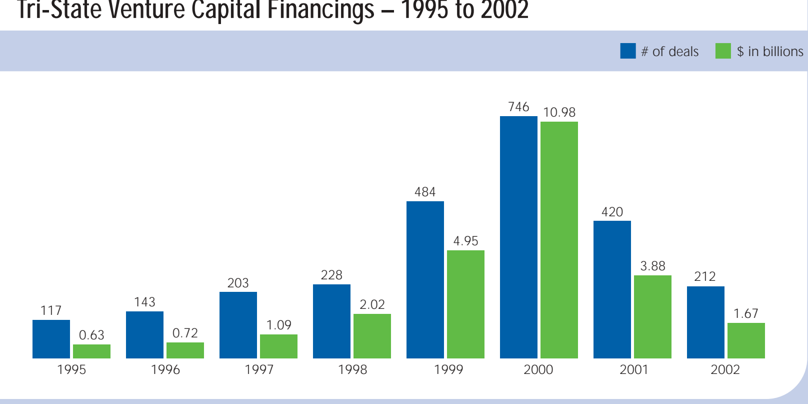
Tri-State

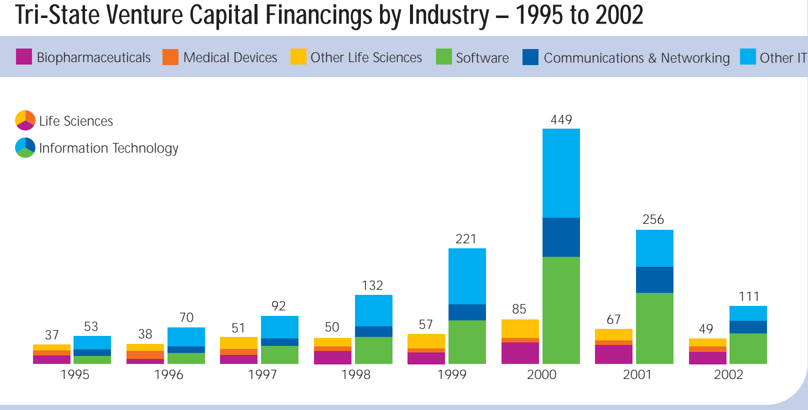
The tri-state region of New York, New Jersey and Pennsylvania experienced a decrease in the total number of venture capital financings from 420 in 2001 to 212 in 2002. The total amount of venture capital financing invested in the region dropped from $3.88 billion in 2001 to $1.67 billion in 2002—and was only 15% of the 2000 figure. However, venture capital activity in 2002 compared favorably to the 1995-1998 period, when there was an annual average of 173 financings raising $1.12 billion.

We believe that the tri-state region's natural strengths in pharmaceuticals, life sciences, financial services and communications and information technologies, coupled with the large number of Fortune 500 companies in the region, will create attractive opportunities for emerging companies in 2003, and that venture capital activity will be comparable to 2002 levels.









Mid-Atlantic

The mid-Atlantic region saw the total number of venture capital financings decrease 23%, from 217 in 2001 to 167 in 2002. The total amount of venture financing raised by companies in the mid-Atlantic region declined to $1.41 billion in 2002 from $2.67 billion in 2001 and $6.96 billion in 2000.

While we do not expect to see a return to the activity levels of 1999 and 2000, which were boosted by investment in Internet-related software and communications and networking companies, we anticipate that the mid-Atlantic region will continue to produce attractive emerging companies as the region receives a boost from increased interest in national security, government contracting and defense-related companies in 2003. We also anticipate that the region—and particularly the Research Triangle area—will remain a vibrant hub of life sciences-related investment.

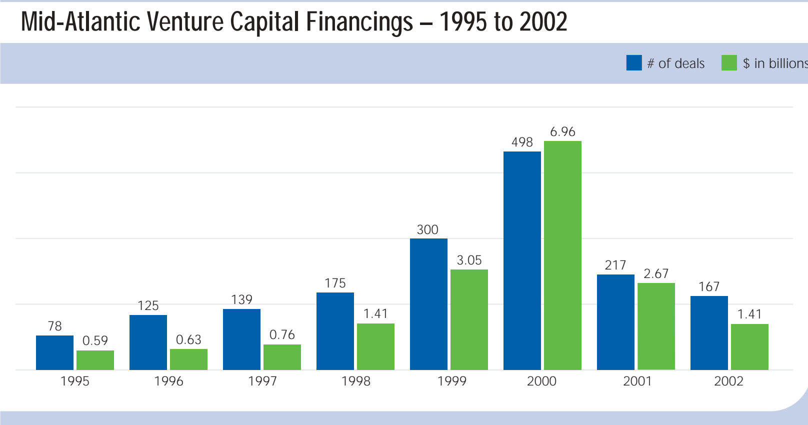
Europe

In 2002, there were 1,029 venture capital financings in Europe, a decrease of 52% from the 2,156 in 2001. The total amount invested in Europe fell by over half, dropping from €10.3 billion in 2001 to €4.2 billion in 2002. While Europe saw a decline in both the number and amount of venture capital financings in 2002, the median amount invested by round declined only slightly, from €2.2 million in 2001 to €2.0 million in 2002.

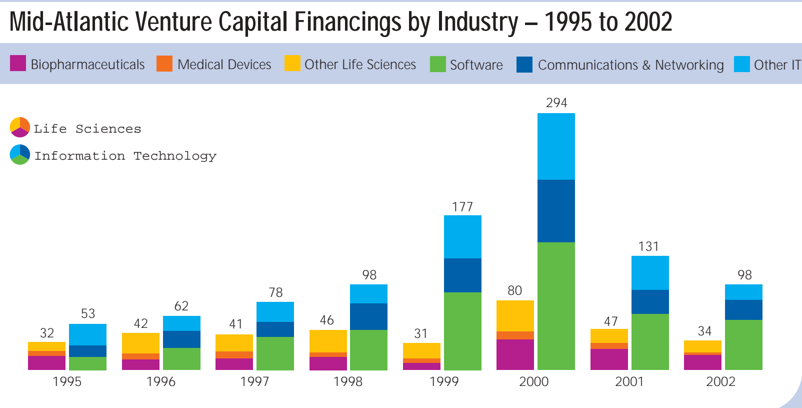
The United Kingdom remains the most active country in Europe based on the total amount of venture capital financing. In 2002, the United Kingdom had a 34% share, followed by Germany at 16% and France at 11%. Software companies received the largest amount of venture capital financing by industry segment, with 31% of the total, followed closely by biopharmaceutical companies with 30%.

While concerns linger about a lack of solid economic growth, the large number of leading academic and research institutions, the growing number of venture capital firms and the fact that the region has a different regulatory environment than the U.S.—particularly for biopharmaceutical companies—should help the European venture capital market in 2003 remain at levels that are at least comparable to those of 2002. ■

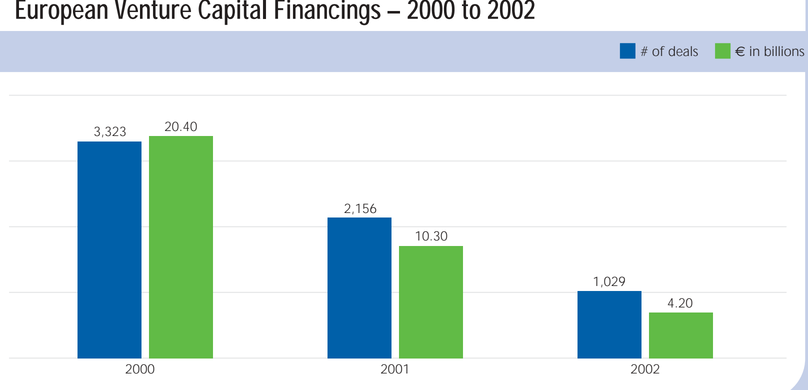
Mid-Atlantic Venture Capital Financings – 1995 to 2002



Mid-Atlantic Venture Capital Financings by Industry – 1995 to 2002



European Venture Capital Financings – 2000 to 2002



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- ***Nominating Committees.*** NASDAQ has proposed that all director nominations be approved by a nominating committee consisting of independent directors or a majority of all independent directors. The NYSE has proposed that each listed company must have a nominating and corporate governance committee consisting solely of independent directors.

Relationship with Auditors

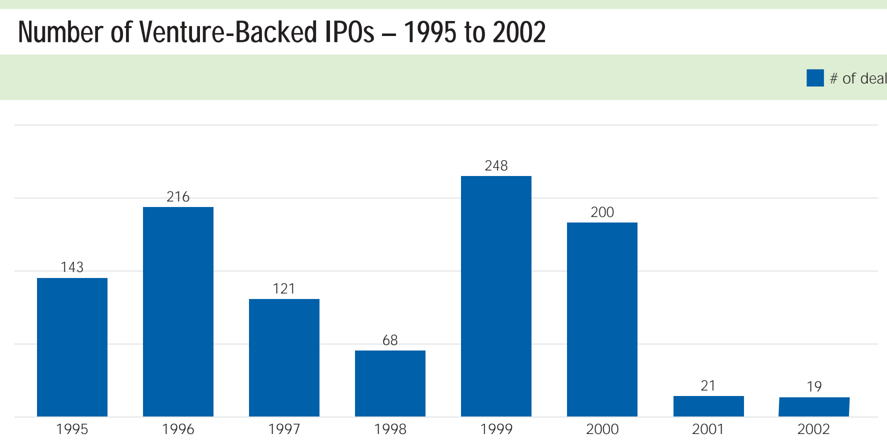
The Sarbanes-Oxley Act will affect a private company's relationship with its accountants:

- ***Prohibition of Non-Audit Services.*** The accounting firm responsible for performing a public company's audit is prohibited from performing specified non-audit services, although tax services generally are still permitted. Private companies receiving prohibited non-audit services from their auditors should be prepared to obtain these services from other parties upon the filing of an IPO registration statement.

- ***Rotation.*** The lead audit partner and the concurring audit partner must be rotated at least every five years, and certain other partners involved in the audit must be rotated every seven years. Thus, a private company beginning the IPO process with an audit partner it has had for four or more years may see that partner rotate off the company's account during or shortly after the IPO process.

- ***Hiring Restrictions.*** An audit firm is not independent if a company's CEO, CFO, chief accounting officer or controller (or another person in a "financial reporting oversight role") is a former employee of the audit firm who worked on the company's audit during the past year. Therefore, a private company should be careful hiring from its accounting firm during the year before it intends to file an IPO registration statement.

Number of Venture-Backed IPOs – 1995 to 2002



- ***Year-End Audit Crunch.*** Venture-backed private companies are typically required to provide investors with audited financial statements within 90 days after the end of the fiscal year. Recently adopted SEC rules that require public companies to file Form 10-Ks sooner following fiscal year end, combined with the increased disclosure requirements for public companies, will likely make it more difficult and costly for private companies to get their audits completed within the required time frame. Private companies concerned about this "audit crunch" could change their fiscal year ends so that annual audits are performed later in the calendar year.

Disclosure Controls and Internal Controls

Public companies are now required to maintain, and periodically evaluate and report on the effectiveness of, "disclosure controls and procedures"—that is, controls and other procedures designed to ensure that information required to be disclosed by the company in its SEC reports is assimilated and processed within the required time periods. The SEC has proposed similar rules regarding "internal controls and procedures for financial reporting"—that is, controls regarding the preparation of financial statements for external purposes that are fairly presented in conformity with GAAP.

Any private company planning to go public should establish appropriate controls and procedures so that it will not need to substantially re-engineer its business processes following an IPO. The IPO underwriters will scrutinize the company's controls and procedures as part of their due diligence process. Similarly, any potential public company acquirer will conduct significant due diligence on the private company's controls and procedures so that the acquirer is in a position to provide all required SEC certifications following the acquisition.

Covenant Creep

As investors and financial institutions change their standard forms and operating procedures in response to the new regulatory environment, some of their new practices and the covenants, representations and warranties that they will require of public companies will inevitably begin to impact private companies. For example, investors in private companies may begin to require audit committees to comply with the membership rules applicable to public companies. ■

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Want to know more about the 2002 IPO market and 2003 outlook?

Please see our companion publication, the *2002 IPO Report*, for analysis, regional breakdowns, an overview of the new regulatory environment faced by public companies and recommendations for pre-IPO planning in the wake of the Sarbanes-Oxley Act.

To request a copy of the *2002 IPO Report*, contact marketing.department@haledorr.com or call 617 526 5600.

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Internet Availability
An electronic version of this report can be found at www.vcleader.com.

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