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NEWS: ANALYSIS & COMMENTARY

Death, Taxes, & Sarbanes-Oxley?

Executives may be frustrated with the law's burdens, but corporate reform is here to stay

Nearly three years ago, Congress set out to clean up the way companies do business after accounting and governance scandals rocked investor confidence and damaged the reputation of companies large and small. Now, as the final stages of reform mandated by the Sarbanes-Oxley Act 2002 go into effect, much of Corporate America is in an uproar. CEOs and CFOs complain they're burdened with huge implementation costs as armies of nitpicky auditors check every corner of their operations. "Common sense is gone," says Wisconsin Energy Corp. controller Stephen P. Dickson, voicing an increasingly common gripe. "You have to document everything."

True enough, it hasn't been the easiest year for CFOs and their staffs. And there's no denying that the costs of implementing Sarbanes-Oxley are high -- upwards of $35 million on average for large companies this year alone. Complicating matters, the promised benefits of the reform movement are hard to spot and difficult to quantify: frauds that never happened, or the boost to investor confidence that has helped bring life back to U.S. markets.

WORTH THE TROUBLE

Fears have thus taken hold that a backlash is under way. Clearly, executive complaints are reaching Washington: The U.S. Chamber of Commerce has targeted Securities & Exchange Commission Chairman William H. Donaldson and is compiling a dossier of examples of what it calls regulatory or enforcement overreach. And concern that the Administration's appetite for reform -- or support for Donaldson -- could wane in the second term were stoked in mid-December when Treasury Secretary John W. Snow called for more "balance" in regulation. Yet despite the grumbling, there's increasing evidence that reform has been well worth the trouble. Already, intense scrutiny of accounting methods and internal controls has unearthed lingering problems in the way companies operate. And fixing weak financial controls has nipped a lot of accounting problems in the bud. "You know the CEOs and CFOs are doing much more due diligence inside their companies," says Neri Bukspan, chief accountant for Standard & Poor's (**MHP**), the credit-rating service. Perhaps most important, the reforms have helped renew investor confidence in companies' reports -- a payoff that will grow in time. Says Donaldson: "The benefit will come in the long haul, with greater credibility in the marketplace and higher stock price multiples."

What's more, there's little chance that the SEC will be reined in. Following Fannie Mae's $9 billion restatement and continued controversy over megamillion-dollar parachutes it handed ousted top execs, corporate scandal is still too fresh to allow politicians to backtrack. The White House made it clear on Dec. 16 that the President "appreciates" the job Donaldson is doing to crack down on corporate wrongdoers. Snow has affirmed his support for Sarbanes-Oxley and Donaldson -- although he still thinks regulators and prosecutors need to better coordinate their rulemaking and probes. "The system may have become too prosecutorial," Snow told *BusinessWeek* on Jan. 4.

Nevertheless, the complaints, which have been growing through the fall, will probably intensify in

coming weeks due to widespread frustration with a single feature of Sarbanes-Oxley, Section 404. It requires that corporate executives and their auditors document, and certify to investors, that their internal financial controls work properly. It is biting hardest now because the first deadlines for completing the work begin taking effect next month for large-cap companies.

The law requires, for example, proof that someone is cross-checking the numbers that make up earnings, such as the value of inventory and receivables. Seems reasonable enough, but execs grouse that auditors are applying the law in mind-numbing detail. "It requires an army of people to do the paperwork," says William D. Zollars, chairman and CEO of Yellow Roadway Corp. (**YELL**), the nation's largest trucking firm. Zollars dispatched some 200 Yellow employees to the task last quarter and paid about $9 million to accountants for their work -- or some 3% of annual profits for 2004.

Costs vary across companies, depending mostly on their complexity, auditors say. A survey of board members conducted by RHR International for *Directorship* magazine found that big companies with $4 billion or more in revenues are spending an average of $35 million to comply with the act. Another survey by Financial Executives International found $3.1 million in added costs for companies with average revenues of $2.5 billion.

SMALL-BIZ HARDSHIP

Those numbers are grist for lobbyists in Washington. The U.S. Chamber of Commerce is collecting such evidence to take to Congress. The group's top priority this year is a "push back" for changes in Sarbanes-Oxley, says David T. Hirschmann, senior vice-president of the Chamber. He'll probably have plenty of ammunition. Mario J. Gabelli, CEO of Gabelli Asset Management (**GBL**), says he put off hiring 12 security analysts in order to pay for complying with Section 404. "It has been a major drag on the economy," Gabelli says. But small public companies may have the best argument, since they have fewer revenues to offset basic compliance costs. "This is a regressive tax against small business," says venture capitalist Gary J. Morgenthaler of Menlo Park (Calif.)-based Morgenthaler Ventures.

While accountants predicted that the internal controls section of Sarbanes-Oxley would be a burden, few people expected there to be this much grief. After all, Section 404 restates what was already required in other federal laws and regulations. Since the late '70s, the Foreign Corrupt Practices Act has required companies to have internal controls, and auditors have long been expected to test them before signing off on financial statements.

Sarbanes-Oxley only adds the requirement that execs and auditors certify the controls work. Lawmakers did that to ensure that top managers were held accountable for problems and to make it easier to prosecute cheaters. "The fact that companies are having difficulty complying, after controls have been in federal law for 25 years, doesn't speak well for the quality of their controls," says one high-ranking regulator.

That may be an understatement. In November, 119 companies publicly reported finding weaknesses or deficiencies in their internal controls, up from 11 in the same month a year before, according to industry newsletter *Compliance Week*. Many problems involved closing books, reconciling accounts, or dealing with inventory. SunTrust Banks Inc. (**STI**) said in November that it had fired three officers after discovering errors in how it calculates allowances for losses in loan portfolios. Visteon Corp. (**VC**), a car-parts supplier, said it found problems recording and managing accounts receivable from its major customer, Ford Motor Co. It's now fixing those problems. "We are finding that the focus on internal controls is uncovering problems at the best of companies," says Samuel A. DiPiazza Jr., CEO of auditor PricewaterhouseCoopers International Ltd.

``MORE CONFIDENCE"

Many businesses are discovering other benefits. General Electric Co. (**GE**), which spent about $30 million on the work last year, "had good controls before this, but it has added more rigor," says CFO Keith S. Sherin. "It certainly gives [CEO Jeffrey R. Immelt] and me more confidence when we're

signing off on the results." United Technologies Corp. (**UTX**) used the work to standardize checks on bookkeeping in its disparate businesses around the world. "We had a fair degree of latitude in how people document things. We've tightened that up," says Jay Haberland, UTC's vice-president for business controls.

The biggest advantage of all, though, may be the greater confidence investors have in financial results. "The auditors are doing better audits and charging for that. More questions are being asked by everyone," says Donald T. Nicolaisen, the SEC's chief accountant. That's why fine-tuning the regs, rather than any kind of rollback, is what's likely this year. Regulators are encouraging auditors to focus on critical issues that pose the biggest risks rather than sweating the little stuff that wastes time and resources -- and drives managers nuts. And come the spring, they have promised to review the complaints and determine whether the procedures can be improved.

Some officials say it could take three years for companies, auditors, and regulators to apply the law efficiently. That may seem like a long march for many executives. Yet in the long run, it will be a small price to pay for more smoothly running organizations and renewed investor confidence.

By David Henry in New York and Amy Borrus in Washington, with Louis Lavelle and Diane Brady in New York, Michael Arndt and Joseph Weber in Chicago, and bureau reports

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