CORPORATE STRATEGY

# One year later: Landmark legislation ripples through corporate America

BY MEG RICHARDS
*Associated Press*

The scandals thundered across the headlines like a noisy storm, failures so spectacular their names now seem synonymous with corporate ruin: **Enron, WorldCom, Tyco, Adelphia.**

Washington's remedy was the Sarbanes-Oxley Act, swiftly signed into law by President Bush on July 30, 2002, and hailed as the most substantial piece of business legislation since the Great Depression.

For many small investors, though, it's not clear what's changed, and experts agree it's too soon to say whether the law will bring about the desired reforms. It's still being implemented, has yet to be tested in court and has yet to see its first penalty imposed.

The way lawmakers saw it last year, just about every link in the chain of information between corporations and individual investors had been compromised or was vulnerable, said David E. Hardesty, an accountant and author of "Corporate Governance and Accounting Under the Sarbanes-Oxley Act of 2002," a guide for securities professionals.

"Each place where information could be altered, either inadvertently or on purpose, Sarbanes-Oxley attempts to fix it," Hardesty said. "These problems were created by people who were willing to take the risk that they could cook the books and get away with it. In today's environment, the feeling is that if we cook the books, we might get caught."

The law aims to make financial information released by public companies as accurate as possible by tweaking the checks and balances already in place. It boosts the independence of corporate boards and auditors and threatens serious sanctions for chief executive and chief financial officers who violate the rules. Among the highlights:

- CEOs and CFOs must certify reports submitted to the **Securities and Exchange Commission**. Criminal penalties of up to 20 years can be imposed if records are altered, destroyed or inaccurately stated.
- A corporate board's audit committee must consist entirely of independent directors and must take control of hiring, overseeing and compensating the company's auditor. To avoid situations that could lead to conflict, the auditor must report directly to the committee rather than to management.
- A new quasi-governmental board has been established to oversee audits, a provision expected to have a greater impact on the accounting industry than any since the 1930s. The five-member board sets quality control standards for audits, inspects and investigates registered accounting firms and has the power to issue subpoenas and impose sanctions for rules violations.
- Accounting firms are prohibited from providing most non-audit services for the public companies they audit. To maintain independence, the law requires the rotation of lead audit partners every five years and limits the ability of auditors to take jobs in senior financial positions at the companies they serve.

The law also called for greater financial disclosures, extended the statute of limitations and expanded the penalties for securities fraud and created new rules to protect "whistleblowers" who report corporate abuses.

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Rep. Michael Oxley, R-Ohio, left, and Sen. Paul Sarbanes, D-Md., respond to a reporters questions, in this Oct 1, file photo, after their meeting with President Bush. The Sarbanes-Oxley Act was hailed as the most substantial piece of business legislation since the Great Depression.

### Still to come

Much of the law's provisions are already in place, but parts won't take effect until regulators and stock exchanges write and formally adopt corresponding rules. One provision not yet in effect is supposed to prevent conflicts of interests for stock research analysts at securities firms. New internal accounting controls won't take effect for another year. It may take years for the law to be fully understood.

"It's very hard for the individual investor to say, 'OK, what have I made off of Sarbanes-Oxley?'" said John Markese, head of the American Institute of Individual Investors. "I think there will be dividends, but they may not pay for a while."

Congress nearly doubled the SEC's budget for the fiscal year beginning Oct. 1, to $841.5 million, and the agency, strained by ongoing investigations and prosecutions, now plans to expand its staff as it steps up routine reviews of annual reports and other filings from public companies. SEC Chairman William Donaldson has vowed to shift the balance of power away from "imperial CEOs" and back toward boards and investors.

The Bush administration's first SEC chairman, Harvey Pitt, arrived in 2001 with a gentler approach to big business. That was before Enron's $63.4 billion collapse took corporate America's breath away and before WorldCom's $103.9 billion failure eclipsed it as the largest bankruptcy in history.

The stunning sequence of fiascos that followed, and criticism of the SEC's tepid response, ultimately put Pitt out of a job and led to an unlikely alliance between two congressmen from opposite sides of the political fence. With midterm elections on the horizon and investors threatening to show their outrage at the polls, Sen. Paul Sarbanes, D-Md., and Rep. Michael Oxley, R-Ohio, authored a bill that would accelerate regulatory changes long resisted by Wall Street.

The legislation doesn't really present any brand new ideas, said Richard Sylla, a financial historian at **New York University's** Stern School of Business. To some extent, he said, it may be simply "a reminder to corporate executives about what they should be doing — a reminder with some new teeth."

In practical terms, the law has forced people to ask more questions. Chief executives are demanding more information before signing off on financial statements and some companies have started internal certification processes in which line managers attest to the accuracy of their own reports. Boards are questioning auditors more vigorously and directors are re-examining their own performances.

"Some CEOs have said to me that they've taken some time to be more financially current," said Steve Mader, president of the executive search firm **Christian & Timbers**. "What that really means is they've grabbed their chief financial officers and spent much more time with them, saying, 'Make me comfortable that I know what you know. Tell me more instead of less.'"

### Challenges

Beth A. Brooke, a partner with **Ernst & Young**, said the firm's auditors are spending much more time with audit committees. The frequency of meetings has increased, she said, and the level of questioning from board members has deepened and broadened. Auditors are asking more questions, too, and may be less concerned about taking adversarial positions with CFOs now that they report exclusively to the board.

"If I'm an investor, I want that audit committee doing its job, and they're required to do it now in a very engaged way," Brooke said. "Sarbanes-Oxley has changed everything for everybody. ... It really does represent in my mind the wall between the past and the present and the future."

The demand for independent financial experts as board members has skyrocketed, with retired CFOs and audit partners among the most attractive candidates. Prospective board members face a host of new concerns, with liability insurance often topping the list. Before agreeing to join a board, many want to talk to the company's auditors, lawyers and other board members, said Andrea Redmond, co-manager of board services at recruiting firm **Russell Reynolds**.

"I had a candidate say, 'What is this group's reaction to dissent? How is that viewed? What is the pressure to conform?'" Redmond said. "They want to know who they're involved with, and they want to make sure the other members are as honest and well intentioned as they are."

**Delphi Corp.**, the largest automotive parts supplier, had a head start on Sarbanes-Oxley. It already was widely praised for its governance practices after being carved out of General Motors in 1999, and because of controls established from the start, Delphi's J.T. Battenberg III was the first CEO to certify a financial statement after it became an SEC requirement last year.

"When I sent it in, they actually called to be sure that we knew what we were doing. It was interesting. To me it was something natural," he said. "What Sarbanes Oxley did for me as a CEO is, it validated the path we were on. ... We haven't had to change much of anything."

For other companies, the task can be more challenging. Only 40 percent of companies expect to be in immediate compliance when the law takes full effect, according to a study by the Business Performance Management Forum. Some decide the cost is too high; the number of companies going private, and thus no longer subject to the law, has jumped 22 percent in the past year.

Many companies are seeing legal, accounting and consulting fees rise as they try to comply. The more bureaucratic aspects of the law can be especially frustrating for some executives; they might object to the idea of forming big committees, establishing extensive procedures and creating tedious paper trails. But in the current regulatory environment, "it doesn't make sense to cut corners," said Douglas M. Hagerman, a securities lawyer with **Foley & Lardner** who has advised companies and boards on governance issues.

"On the one hand you have companies trying much harder to get it right on corporate governance, and on the other hand you spend an awful lot of time trying to figure out, 'How can we comply without doing something we don't want to do?'" Hagerman said.

### Setting up defenses

The law's detractors grumble that the requirements are too onerous, but the long-term benefit of providing more comprehensive information to investors and improving corporate defenses against internal fraud far outweigh any additional costs, said Patrick McGurn, chief counsel for **Institutional Shareholder Services**.

"I've asked executives who have naysayed this process to point to something that has stopped them from making good business decisions or taking risks, or to show where the costs are so great they're stopping the corporation from moving forward, but it's a lot of rhetoric," McGurn said. "There's no meat on their arguments."