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REINING IN CORPORATE GREED?

THE LONG ARM OF SARBANES-OXLEY

WITH THE IMPLEMENTATION OF SARBANES-OXLEY IN FULL SWING, COMPANIES ARE MAKING A DISTINCT MOVE BACK TO THE FUTURE, COMBINING TRADITIONAL BUSINESS VALUES WITH SIGNIFICANT STRUCTURAL AND OPERATIONAL CHANGES. BY KIMBALL THOMSON

FREDRIK BRÖDEN

SOMETHING OLD, SOMETHING NEW

In contrast to the go-go '90s, the first four years of the new century have seen a return to business basics, such as bottom line profitability and accountability. "Business fundamentals are king again," says Dick Clayton, a partner at the Salt Lake offices of Holland & Hart and founder of the business accelerator Technology to Market. "During the '90s we had dot-coms talking about virtual Internet space that would turn into huge money, and other things that simply didn't pan out. Now it's back to fundamentals, back to the numbers."

In concert with this renewed emphasis on the tried, true and familiar, however, there are seismic shifts afoot in corporate governance, both in the internal structures of companies and in the relationships between management and boards of directors, outside auditors and legal counsel.

LIKE Y2K EVERY YEAR

Much of this change is a reaction to the visible hand of government regulation—in particular the sweeping mandates in the 2002 Sarbanes-Oxley Act. A response to the corporate scandals of the 1990s and early 2000s, the Sarbanes-Oxley legislation passed by a 97-0 margin in the Senate and was signed by President Bush only six weeks after it was introduced to the Senate floor.

"Imagine having the compliance equivalent of Y2K every year," says former U.S. Senator Jake Garn, past chairman of the Senate Banking Committee, in reference to the mountain of work IT departments did prior to the January 1, 2000 to prepare for the new millennium. "That's the magnitude of what a lot of companies need to do in order to comply with this new legislation."

While Garn believes that legislation was necessary to curb the ethical lapses of the previous decade, he argues that Sarbanes-Oxley was ill-conceived and excessive in its requirements. "There is no doubt about the need for legislation," he says, "but Congress should have taken the time to do it in a more reasoned manner, bringing in more people to testify about what would help and harm. It just is amazing to me—the impact this is having on companies big and small, especially smaller public companies."

Garn refers to one company that spent north of $1 million in accounting fees to track some small errors the SEC accused them of making. "They finally found it, and it was an $8,000 error," he says. Garn estimates that overall accounting costs have at least doubled for most public companies, and many private companies. "I know of other companies that have had to audit their books for the past three years and have spent hundreds of thousands or millions of dollars and found absolutely nothing wrong," he says. "Talk about overkill."

Clayton lends evidence supporting Garn's contention about the exorbitant cost of Sarbanes-Oxley compliance. "Most studies I've seen show that for micro-cap companies, the annual costs of compliance start at $150,000," he says. "That's more than the profit margin for a lot of micro-caps, and it's only the entrance fee."

Garn argues that monetary expenses aren't the only significant costs brought on by the new legislation; those costs may be equaled or even exceeded by the opportunity costs of the time, focus and resources diverted away from value- and profit-generating activities. "This is time and energy that should be going toward building better products and focusing on sales and marketing," he says.

Ironically, because of the exorbitant capital, time and focus required for companies to comply with Sarbanes-Oxley, the net effect of Congress' attempts to protect individual shareholders and consumers may be lower share values for shareholders and higher prices for consumers. "The average person doesn't realize who is paying for all these accounting fees and other expenses," says Garn. "They are reflected in rising prices for products and services and falling earnings per share."

Garn is one of a large and loud chorus of voices calling for modification of Sarbanes-Oxley. But he is quick to acknowledge that changes, though on the horizon, will not likely be imminent, nor sweeping.

THE NEW BOARD OF DIRECTORS

In the meantime, the legislation exerts gargantuan influence on business. "It may be a while before we see all the ripple effects of Sarbanes-Oxley," says Mark Bonham, a partner in the Utah offices of Wilson Sonsini Goodrich & Rosati. "But some of them are already clearly apparent."

Some of these ripples are moving directly to the heart of companies' strategy and structure. One of the earliest and most significant changes taking place in the current environment is a new approach to boards of directors.

Young companies planning to go public in the near future—or who plan to grow very large but remain privately held—are behaving progressively more like big companies in embryo. "Shareholders are pursuing board members increasingly independent of the CEO, and really expecting a lot of work and performance from those directors," says Clayton. This represents something of a sea change. "Before, companies often looked for big names to bring notoriety or perceived credibility to their companies. Now they are looking for people who will roll up their sleeves and add value."

Bonham adds that the new director class is increasingly financially astute and independent from management's control. "There is a big emphasis on finding directors who can serve on audit committees," he says.

As a result of the increased liability, expertise and work required of board members in the current environment, their remuneration is increasing. According to Bonham, the average cash and stock compensation for directors is $40,000 per year: "Not bad for someone working two or three days a month. A lot of seasoned executives may decide to work on two or three boards and call it a good semi-retirement."

There has long been something of a cottage industry for professional directors, but with public companies' need for financial experts along with the requirement that a majority of the board members be independent, says Bonham, "I believe we will see more of these folks on boards. It may not be the CEO's favorite thing, but frankly I think many of these people will be really good directors. They will be very independent and have a great sense of what they are doing."

Clayton predicts that one particular class of directors will become increasingly scarce: CEOs from other companies, whose own companies are growing increasingly jealous for their attention and focus. "Companies want their CEOs' full attention," he says, "so many of them are adopting rules requiring that they not sit on other boards." In addition, he says, boards are refusing to bring on members that sit on more than three or four boards, "so they are not spread too thin."

A NEW CLASS OF CORPORATE OFFICERS

In addition to the re-constituted board of directors, the long arm of Sarbanes-Oxley is reaching into the fundamental structure and function of companies. The legislation's intense scrutiny, prolific reporting and management accountability requirements have accelerated the creation of a new class of hybrid corporate officers—part legal specialist, part corporate strategist. Many of these officers sport flashy new titles, such as "chief legal officer" or "chief compliance officer."

As legal issues become a more integral part of a company's strategy, says Clayton, these new hybrid executives play a more central role within their companies. "These are executive-level people who actually have to know how the company operates on a high level and are involved in the decision-making processes and strategy councils," he says. "This is really a dramatic shift. A few years ago, compliance officers—if companies even had any—were relegated to lower levels in the company. Now they are given more and more credibility and authority. Chief legal officers, for example, typically have a much more elevated role than that associated with general counsel."

The rise of this new class of executives is being accelerated by the increased pressure and accountability placed on CEOs and CFOs within companies to meet the multifarious demands of Sarbanes-Oxley. "Sarbanes really raises the bar on the accuracy of financial information and the accountability of management for ensuring that accuracy far beyond anything GAAP (generally accepted accounting practices) required," says Clayton. "Now the CEO and CFO have to sign on the dotted line saying their records are a true indicator of the financial condition of the company. The CEO and CFO have to be committed to meeting those requirements; they either adapt, or they will likely be replaced."

Beyond this commitment, however, the CEO and CFO are generally not going to be personally handling all these requirements, so increased trust and responsibility passes to the new legal and compliance officers.

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SHIFTING ATTITUDES AND RELATIONSHIPS

Pressure not only follows from the legislation. Auditors, legal counsel and investors too are turning up the heat.

With the disbanding of Arthur Andersen and the intense scrutiny placed on the remaining "Final Four" big audit firms, says Bonham, "There is a huge note of caution on the part of auditors, driven by genuine fears about keeping or taking on what they perceive as risky clients." These firms are setting a high standard, requiring client companies to provide them information and set up practices the auditors are comfortable endorsing, and companies need to hit that bar. No company wants to send the signal to the marketplace that it was dumped by its auditor.

Bonham adds that outside legal counsel has also been significantly affected by Sarbanes-Oxley, if not to the same extent as the auditors. "We are spending an awful lot of time and energy trying to help companies understand what they need to comply with," he says. Beyond the increasing legal fees for clients, companies don't want to face the public ignominy of being "fired" by their legal counsel.

Clayton adds that Sarbanes-Oxley requirements also strain relations between auditors and law firms. For example, he says, standard letters auditors send a company's attorneys as part of the annual audit are changing. "This year, some of these letters are going way beyond the standard questions about receivables, payables, legal and litigation risks; they are asking about any potential criminal activity at Company X. It's a result of Sarbanes-Oxley and puts us in a tough position, because our loyalty must be to our client, yet we don't want to hurt our relationship with the auditors."

Another major transition in the marketplace, adds Bonham, is a change in investment patterns. "The center of gravity has shifted away from mainstream venture capital into private equity funds that are more likely to engage in buyouts or take a majority position in portfolio companies," he says. This trend increases the chances that management will be replaced, or that the company may be moved to another locale, generally closer to the investors' headquarters.

Clayton also notes increasing shareholder activism, in particular from large institutional investors, who in the past have taken a more passive role in day-to-day management issues. "Large institutional investors are actually beginning to closely scrutinize management and governance and to step in more than they have before." Some large funds are taking seats on boards of directors and pushing for changes in management where they deem it necessary.

WHERE DO WE GO FROM HERE?

So what does a company's leadership need to do in order to survive and prosper in this post-Sarbanes-Oxley world?

Clayton advises business leaders to remember that they are running a business, not a legal or auditing firm. "They can't let the new legal and procedural requirements take their eye off the ball of running their companies effectively," he says. "That's where their focus needs to remain."

At the same time, adds Clayton, "It was always good practice to make sure your policies and procedures were in good order, and you were covering your legal, environmental and antitrust risks. Now it's a mandated obligation."

According to Bonham, companies need to focus early and directly on corporate governance. "It is essential that companies get Sarbanes compliance into the DNA of their companies, so they don't have to spend a lot of cycles on that and can get back to business," he says.

What, then, should ultimately be done about Sarbanes-Oxley? Garn urges leaders to usher in a referendum on the current legislation. "I think business leaders throughout the country need to stand up together and say to Congress, 'We agree with you that legislative standards were needed to fix these problems, but let's do it reasonably; let's eliminate the Enrons and other bad guys out there without causing more problems and expense than the criminals were causing.'"

By re-examining and re-working Sarbanes-Oxley, Garn believes we can establish the honesty, candor and public debate that Congress was trying to achieve, without punishing the innocent along with the guilty: "What we have now is akin to firing the entire Senate because a few of them acted unethically. We have simply got to fix this."

Kimball Thomson is senior editor of Utah Business *magazine.*

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