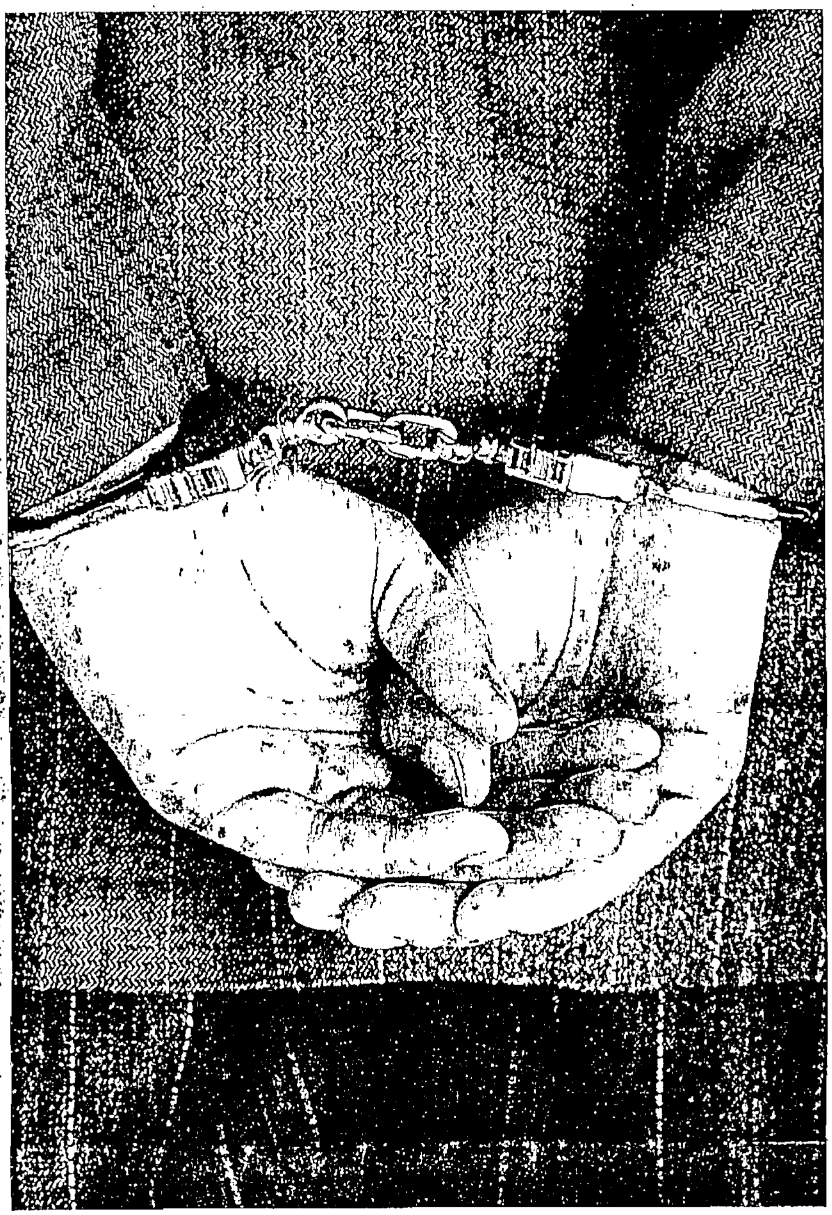
FIGHTING FRAUD

The hefty costs of compliance

Small, midsize public companies hit hardest by Sarbanes-Oxley



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Plain Dealer Reporters

At Hawk Corp., a Cleveland maker of brake pads and clutches, Chairman and Chief Executive Ron Weinberg gets a taste of the new corporate accounting law when he orders lunch to go.

"I have to initial the little chit that says three chicken sandwiches," he said.

Authorizing a takeout meal is the least of it: Getting Hawk's books and processes in shape to comply with the Sarbanes-Oxley Act has gobbled close to $1 million, Weinberg said. Hawk has invested hundreds of employee hours in evaluating its internal controls, hired a consultant to oversee the project and bought new software to track its documents.

It's a lot for a small-cap company with annual sales of less than $250 million.

Described as the biggest corporate regulatory change since the 1930s, Sarbanes-Oxley has fallen hardest on small and midsize public companies, experts say. Companies must vet — and remedy, when necessary — hundreds of procedures and practices, from signatures to big-picture issues such as assuring director independence.

Marc Morgenstern, managing partner at the Cleveland law firm Kahn Kleinman, calls Sarbanes-Oxley "one of the best examples of a law with unintended consequences."

Small public companies, like Hawk, bear nearly as much compliance cost as large companies. "Is giving up one-third of my profit worth it for the benefit I'm getting? Not many companies would say yes," Morgenstern said.

Morgenstern expects many small and midsize companies to look for buyers or to go private through leveraged buyouts or other transactions. He expects many more companies to simply remove themselves from stock exchanges, avoiding the cost of complying with Sarbanes-Oxley.

The Securities and Exchange Commission responded to complaints this month by giving foreign companies, and U.S. corporations with assets of $75 million or less, a one-year extension to file reports on their controls.

SEE RULES | C3

Sarbanes-Oxley Act of 2002

"An act to protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws, and for other purposes."

The Sarbanes-Oxley Act was designed to restore investor confidence after a string of corporate accounting frauds. The law is changing corporations as profoundly as securities laws did after the crash of 1929. It has 11 parts:

Title I. Sets up Public Company Accounting Oversight Board, to oversee public-company auditors.

Title II. Sets rules to ensure auditors are independent and not biased against investors.

Title III. Strengthens rules about financial reporting, auditing and corporate governance.

Title IV. Increases corporate financial disclosures.

Title V. Sets rules requiring unbiased research from securities analysts.

Title VI. Gives Securities and Exchange Commission and federal courts power to enforce the new rules.

Title VII. Calls for studies of firms that provide accounting and financial services.

Title VIII. Sets punishments for corporations guilty of accounting fraud.

Title IX. Adds to penalties for individuals guilty of corporate fraud.

Title X. Recommends that public company tax returns be signed by CEOs.

Title XI. Stiffens penalties for record-tampering or other hindering of corporate fraud investigations.

RULES

FROM C1

The hefty costs of complying

Large businesses have to file the information by tomorrow. The commission also has scheduled a roundtable discussion on the issue for April 13.

Sarbanes-Oxley critics doubt the law will do much to halt the off-balance-sheet financing and fraud at companies like Enron Corp. and WorldCom Inc. that spawned it.

"The big, high-profile problems were because someone wanted to take a shortcut," Weinberg said. "It wasn't because there weren't two levels of signoffs on chicken sandwiches."

Ted Frank, president of Axentis LLC, a Warrensville Heights maker of software that helps companies comply with Sarbanes-Oxley, said no rules are watertight. "Criminals find ways to take advantage of whatever system exists," he said.

But the SEC says the law is helping restore investor confidence in a stock market shaken by accounting scandals.

"Sarbanes-Oxley has recognized fairness towards shareholders — that a company is not run just for the benefit of management," Weinberg said.

And regulators hope the law will steer companies along the straight and narrow by making chief executives and chief financial officers personally vouch for the integrity of their financial statements and internal controls.

Even the law's critics admit its tough standards have helped them tighten accounting practices to avoid potentially damaging mistakes. And some companies have identified and cured operating problems that added cost and hurt efficiency.

"The company does benefit," said Julie Grant, as associate professor of accountancy at Case Western Reserve University. "This is not like a dead-weight requirement."

The act also has been a windfall for thousands of smaller accounting firms. The Big Four firms are farming out Sarbanes-Oxley work because new conflict-of-interest rules prohibit them from doing that work in addition to a company's regular audit. Lawyers and software makers also are seeing more business as companies reach for compliance help.

Interviews with some Northeast Ohio businesses point out the ups and downs of the law known to many as SOX:

Cost RTI International Metals Inc. said implementing Sarbanes-Oxley cost it $6.5 million last year. The company reported losses for 2004 of $2.8 million. The Niles company is one of the world's largest producers of titanium.

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> *chairman and chief executive at Hawk Corp.*

The initial costs of compliance "took us from making money to losing money," RTI spokesman Richard Leone said.

Some of RTI's Sarbanes-Oxley costs were one-time expenses, but it noted that other compliance spending will be ongoing.

Manpower Applied Industrial Technologies Inc., like Hawk, has spent about $1 million on Sarbanes-Oxley so far, mostly to hire consultants. But another big toll has been the drain on existing staff.

Chief Financial Officer Mark Eisele says employees have logged more than 10,000 hours on the project. AIT has a management team that oversees the evaluation, plus support teams from finance and information technology.

Eisele said the corporate governance mandates in the act are good for investors and should bolster trust. But "the jury is still out as to whether the internal control review processes are a cost-effective way to improve investor confidence," he said.

Board changes Sarbanes-Oxley has caused most public companies to re-examine their boards for director independence, Morgenstern said.

Sarbanes-Oxley boosted standards for all directors and required financial expertise for some. "Finding qualified directors has become a new growth industry in the recruiting world," said the legal expert on securities and corporate transactions.

Several Northeast Ohio companies have replaced insiders — the company's own executives or founders, for instance — with independent directors, some with specific financial knowledge.

In 2003, Hudson fabrics and crafts retailer Jo-Ann Stores Inc. replaced two of its founders with a senior vice president of finance for Limited Brands Inc. and an executive vice president and chief information officer for Office Depot Inc.

Developers Diversified Realty Corp., to make clear its directors' independence, removed two company executives and its outside legal counsel from its board. Chairman and CEO Scott Wolstein announced the changes "with great personal regret but with a view towards making our standards of corporate governance as high as any in the industry."

Services boom On the other side of the compliance costs, the audit work done by the Cleveland office of accounting firm Grant Thornton has doubled because of Sarbanes-Oxley, said Jim Sanfilippo, managing partner. He has added about 15 people to his staff of roughly 100 in the last four or five months.

Sarbanes-Oxley also means more business for law firms, Morgenstern said. "There is a tremendous amount of more to day-to-day counseling and interaction with clients than prior to Sarbanes-Oxley," he said.

As is true with most new laws, interpretative disagreements and litigation will pop up in the next year or two. These activities, too, generate business for lawyers.

Insurers have made money on Sarbanes-Oxley, too: The law has boosted the cost of insurance for directors and officers. Some companies are paying four times more to insure directors against wrongdoing than just three years ago.

And Sarbanes-Oxley "has been an enormous gain to us," said Frank, the Axentis executive. Users of Axentis Enterprise, the company's Sarbanes-Oxley software, doubled last year, he said.

Some companies turn to Axentis software in a "fire drill response" to put out compliance fires started by the law, Frank said. For instance, "one of the requirements for Sarbanes-Oxley is to have a hot line for ethics and issue reporting," he said. "We will help with that."

Other companies also use the software to manage training and certification for compliance functions and to manage "incidents," such as an employee theft.

"A lot of times, the processes involve judgment calls that are very subjective," Frank said. "We need to surround people with information and help them make decisions."

Plain Dealer reporter Thomas Gerdel contributed to this story.