streetwise

BY STEPHEN BARLAS, GREG NAINANI, LANCE THOMPSON, CURT VERSCHOOR, KATHY WILLIAMS

[NEWS]

SEC Expands Financial Expert Definition | Kathy Williams, Editor

AFTER RECEIVING A BARRAGE OF PROTESTS OVER THE DEFINITION OF FINANCIAL expert in the Sarbanes-Oxley Act (see IMA's letter, p. 35, and Government, p. 24), the Securities & Exchange Commission (SEC) voted on January 15 to change the term to "audit committee financial expert" and expand the proposed definition beyond someone with experience in "preparing or auditing financial statements."

Now, an audit committee financial expert will be a person who has:

- An understanding of financial statements and GAAP;
- An ability to assess the general application of those principles in connection with the accounting for estimates, accruals, and reserves;
- Experience preparing, auditing, analyzing, or evaluating financial statements that present a breadth and level of complexity of accounting issues that are generally comparable to the breadth and complexity of issues that can reasonably be expected to be raised by the registrant's financial statements, or experience actively supervising one or more persons engaged in such activities;
- An understanding of internal controls and procedures for financial reporting;
- An understanding of audit committee functions.

A person can acquire these attributes through:

- Education and experience as a principal financial officer, principal accounting officer, controller, public accountant, or auditor or experience in one or more positions that involve the performance of similar functions;
- Experience actively supervising a principal financial officer, principal accounting officer, controller, public accountant, auditor, or person performing similar functions, or experience overseeing or assessing the performance of companies or public accountants with respect to the preparation, auditing, or evaluation of financial statements; or
- Other relevant experience.

This paves the way for some CEOs and others to be listed as audit committee financial experts who wouldn't have been allowed under the original definition.

For a complete set of the proposed rules changes regarding Sarbanes-Oxley, visit the SEC's website at www.sec.gov.

More Proposed Accounting Reforms

Last month the Conference Board's Commission on Public

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FASB RELEASES SFAS NO. 148

The Financial Accounting Standards Board has issued Statement of Financial Accounting Standards No. 148, "Accounting for Stock-Based Compensation—Transition and Disclosure," an amendment of SFAS No. 123, "Accounting for Stock-Based Compensation."

It provides alternative methods of transition for a voluntary change to the fair-value-based method of accounting for stock-based employee compensation. It also amends the disclosure requirements of SFAS No. 123 "to require more prominent and more frequent disclosures in financial statements about the effects of stock-based compensation."

For a copy of the Statement, contact the FASB's order department at (800) 748-0659 or www.fasb.org. ■

READERS' INPUT

STOCK OPTIONS

A reader states on page 22 of the December 2002 issue that the authors of "Much Ado About Nothing" [October 2002] should know better than to assert that expensing of stock options would have nil affect on stock valuations. The reader justifies his views with references to academic journals that show a relationship between reported earnings and share price. Although the correlation between reported earnings and stock price is undeniable, the reader fails to realize that reportable earnings only affect stock price because of the informational content about the expected future cash flows.

When companies report higher than expected earnings, stock price usually increases because the information communicated is typically one of higher cash flow. But if companies were to report lower earnings because of a cash neutral event (i.e., expensing of stock options), there would be no effect on share price. If all information is disclosed, share price is not affected by how it is disclosed (i.e., reportable earnings vs. footnotes). Earnings only affect stock price to the extent they impact cash flow.

Accordingly, the assertion expressed in the article that expensing stock options will have nil effect on stock price is indeed consistent with academic studies that show a correlation between reported earnings and stock price.

Greg Nainani, CMA, CFM

[ETHICS]

Will New Law Result in More Whistle Blowing?

by Curtis C. Verschoor, CMA, Editor

THE SARBANES-OXLEY ACT OF 2002 (S-O) CONTAINS A DIVERSE COLLECTION of provisions intended to improve the quality of financial reporting by publicly held companies. Some of the provisions of the act that have received relatively little media attention are those designed to encourage employees of public companies to come forward with otherwise confidential information about a financial crime.

Section 806 directs companies to adopt procedures to protect employees who provide information about corporate financial wrongdoing. Companies cannot "discharge, demote, suspend, threaten, harass, or in any way discriminate" against such employees. The law authorizes criminal penalties for violators.

S-O also encourages "whistle blowing" by motivating publicly held companies to have a more open culture that is sympathetic to employees having a "reasonable belief" that a law has been violated. It requires audit committees of boards of directors of public companies to have a system for tracking and acting on anonymous information from employees.

The whistleblower provisions of S-O seem to provide a significantly different approach from prior law, which varied significantly from state to state. In the past, employees of publicly traded companies complaining about fraud had little or no legal federal protection because such issues hadn't been viewed as having a direct effect on the public welfare. Now, workers must notify the OSHA section of the U.S. Labor Department within 90 days of the alleged retaliatory act. If OSHA fails to take action on an employee complaint within six months thereafter, the employee can sue the employer in federal court, but only for back pay and reinstatement (which the employee may not want to pursue.) Thus, whistleblowers may still face months or years of emotional and financial turmoil.

Reflecting the increasing importance of corporate governance, a worldwide survey of senior executives sponsored by KPMG showed that 46% of respondents said that corporate governance is one of their organization's top three current priorities—for 14% it is the top priority. Yet 51% of the same respondents said that cultural and managerial hostility to whistle blowing on dubious practices was one of the top two barriers to implementation of proper corporate governance policies.

The IMA Standards of Ethical Conduct, available at www.imanet.org/ethics, clearly point out that practitioners of management accounting and financial management have responsibilities beyond themselves and their employer. They have an obligation to their profession and the public to maintain the highest standards of ethical conduct. They also should not condone commission of acts contrary to the Standards by others within their organizations. CMAs, CFMs, and other members annually pledge to comply with the Standards when they pay their dues.

In the section covering confidentiality, the Standards state that a practitioner should "refrain from disclosing confidential information acquired in the course of their work except when authorized, unless legally obligated to

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[GOVERNMENT]

Companies Not Excited about Prospective Internal Controls Report | Stephen Barlas, Editor

IT WILL COME AS NO SURPRISE TO anyone familiar with the controversial history of SEC proposals on internal controls reporting—none of which were ever approved—that the latest proposal, born of the Sarbanes-Oxley accounting reform bill of this past summer, has ticked off any number of corporations and their trade associations. The proposed rule the SEC issued last October requires a company's management to include in the annual report an internal control report that states management's responsibilities for establishing and maintaining an adequate internal control structure and procedures for financial reporting and that contains an assessment, as of the end of the company's most recent fiscal year, of the effectiveness of the company's internal controls and procedures for financial reporting. Section 404 of Sarbanes-Oxley, which contains the provision, also requires a company's independent accounting firm to attest to and report on management's assessment.

...we are concerned that the costs of mandated attestation procedures and the report from the independent accountants may be significant...

A typical response to the proposal came from Ronald Olejniczak, VP and controller at Aetna, Inc. He said Aetna supported the management report and the attestation by Aetna's independent accountants, "However, we are concerned that the costs of mandated attestation procedures and the report from the independent accountants may be signifi-

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BOOKS

Improving Business Performance

✷ **THE FIELDS OF PERFORMANCE MEASUREMENT** and management control have changed dramatically in recent years. Industry has recognized the importance of the implementation and coordination of strategy with organizational structure, management systems, and managerial behavior. Managers and researchers are looking for better ways to link performance metrics to strategy through systems like balanced scorecards and shareholder value analysis and to drive improved business performance.

Performance Measurement and Management Control: A Compendium of Research, edited by Marc Epstein and Jean-Francois Manzoni, is a compendium of the papers presented at a workshop on performance measurement and management control held in October 2001. Leading scholars from around the world attended this conference sponsored by the European Institute for the Advanced Study in Management and held on the campus of the EDHEC School of Management in Nice, France. Research studies were presented discussing new frameworks for management control and the implementation of strategy and how the use of various strategies, structures, and systems impact ultimate performance.

Managers and researchers are looking for better ways to link performance metrics to strategy...

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cant, ultimately exceeding the benefit to investors." Olejniczak added, "We also believe that without publication of standards by the newly established Public Company Accounting Oversight Board (PCAOB), there may be insufficient information to adequately address cost/benefit issues. Therefore, we strongly suggest the SEC delay implementation of this aspect of the Proposed Rules until the PCAOB develops attestation standards and there is an opportunity to adequately weigh these issues." Frank Brod, chairman of the Financial Executives International's committee on corporate reporting, used almost the same language in his letter to the SEC, as did many others.

Designating a "Financial Expert" on Audit Committee

Brod weighed in on the proposed definition of financial expert, too, and not very happily either. "We strongly disagree with the definition of a financial expert that has been proposed by the Commission," he wrote. Brod called the definition "inappropriately restrictive." Darla C. Stuckey, corporate secretary of the New York Stock Exchange, Inc., complained that the SEC's proposed definition would rule out "even the chief executive officer or chief operating officer of a multi-billion dollar company if that person had never prepared an audit—even though the individual had many years of experience reviewing and being ultimately responsible for the financial statements of his or her own company." Harris Miller, president of the Information Technology Association of America (ITAA), maintained the definition is so narrow that it would exclude qualified individuals like investment bankers, commercial bankers, government officials, and venture capitalists who have strong financial analysis credentials. "The approach seems to set up a protectionist scheme around certain individuals, or certain organizations, and could be construed as an endorsement of those people or groups by the federal government," Miller argued.

SEC Budget Still an Issue

SEC Commissioner Harvey Goldschmid, who was as much responsible for Chairman Harvey Pitt's resignation as anyone, took an evermore visible role at the Commission both before and after the Bush administration nominated William Donaldson to replace Pitt. Goldschmid, a Democrat, publicly sparred with the Bush administration over the SEC budget. Congress left town last year without approving the SEC budget for fiscal 2003, which inconveniently started last October 1. The Sarbanes-Oxley bill, among the many things it did, fixed the SEC budget for fiscal 2003 at $776 million, an incredible 77% increase over fiscal 2002. The White House is backing a more modest fiscal 2003 SEC expenditure of about $568 million. Amy Call, a spokeswoman for the Bush administration's Office of Management and Budget, says the President has provided $30 million over the past year to the SEC to pay for hiring 100 new employees, plus $100 million more in emergency funding. "We'll work with Congress on additional funds for the SEC, but we haven't endorsed a specific figure," Call said. ■

[ETHICS] *cont'd from p. 2*

do so." This language mirrors that of the international standard for accountants set forth by the International Federation of Accountants and of other professions. Thus, the bar prohibiting external whistle blowing is set quite high.

In the Resolution of Ethical Conflict section of the IMA Standards, practitioners are directed to consider discussing the ethical conflict with their immediate superior or the next higher managerial level. The Standards also suggest consulting with an objective advisor, such as the IMA Ethics Counseling Service or an attorney. After exhausting all levels of internal review, there may be no other recourse than to resign from the organization. At that point, the Standards agree the practitioner has no obligation to his/her former employer and may find it appropriate to notify other parties.

QUESTIONS:

1. Should the IMA Standards be revised to recognize the encouragement for whistle blowing contained in Sarbanes-Oxley? If so, why? How should they be changed?
2. How can management accountants and financial managers best help their organizations achieve the proper ethical culture?

Please share your thoughts with other IMA members and send comments to the editor of *Strategic Finance* at kwilliams@imanet.org. ■

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[NEWS] *cont'd from p. 1*
Trust and Private Enterprise released a report recommending a wide range of actions to improve corporate governance, auditing, and accounting practices. It had issued its recommendations on executive compensation in September 2002.

Formed in June 2002 "to address the causes of declining public and investor trust in companies, their leaders, and America's capital markets," the 12-member Commission delved into the recent corporate scandals to come up with ways to make sure such events would rarely happen again. In releasing their findings, they said that a key factor would be establishing "an appropriate balance between managing the corporation and providing the independent directors on the board with the powers and resources they need to perform their roles of oversight of management, legal, and ethical compliance."

One of its recommendations is three alternative board structures: one in which the offices of chairman and CEO are separate; one in which the roles of chairman and CEO should be performed by two people, and, if the chairman isn't "independent" according to strict stock exchange definitions, a "lead independent director" should be appointed; and one in which a "presiding director" position should be established if the board doesn't want to separate the chairman and CEO positions. If companies don't follow one of these structures, they should have to explain why.

Regarding auditing and accounting, the Commission says the audit committee and other watchdogs should have a strong role, and companies should have a strong internal audit function. They also recommend that external auditors should confine their roles to auditing, that companies should rotate their auditors every few years, and that the business model of accounting firms should be reevaluated to ensure that quality audits are firms' highest priority.

For a copy of the 46-page report, visit www.conferenceboard.org, and click on "Public Trust Commission Proposes Corporate Governance, Auditing Reforms."

FASB Issues Guidance on SPEs and More

The FASB has issued Interpretation No. 46, "Consolidation of Variable Interest Entities," which is an interpretation of

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ence, the book includes 16 research studies by scholars from North America, Europe, and Australia covering such topics as:

- A New Direction in Management Control and Performance Evaluation
- Management Control in Large Organizations
- Balanced Scorecard and Performance Measurement
- Performance Measurement and Reporting
- Drivers of Performance, Risk, and Financial Analysis

It presents experimental, analytical, empirical, and field studies that contribute to the growing body of knowledge on performance measurement and management control and lead to an improved understanding of how to create better organizations and evaluate their performance.

Some of the issues included in the research are the drivers of corporate performance, the linkages between them, and how they impact profitability. These studies help to develop a better understanding of the conditions under which different performance measurement and management control systems are more or less effective, how they align with various organizational structures and strategies, and the causes of their successes and failures. Included are both profit and nonprofit organizations from Europe, the United States, Canada, Australia, and China and a wide variety of different industries such as manufacturing, healthcare, high-technology, financial services, and Internet businesses.

It's difficult to summarize the studies, which are grouped into the above five sections. Many of the studies mention the Balanced Business Scorecard developed by Kaplan and Norton and its success as a tool for strategic alignment, goal clarification, and for supporting cultural and learning improvements. One of these studies confirms what we have learned from the dot-com craze—successful performance measurement approaches for Internet-based new ventures are an adaptation and integration of existing models, not a new revolution.

Another study examines the connections among strategy, strategic performance drivers, and financial ratios of three exceptional companies with different strategic value disciplines (from Michael Treacy and Fred Wiersema's *The Disciplines of Market Leaders*) for Dell Computer (Operational Excellence), Intel (Product Leadership), and Four Seasons Hotels and Resorts (Customer Intimacy).

A third study examines the balanced scorecard as a performance measurement driver of change in hospitals. This research concludes that balanced scorecards are popular and practical performance measurement tools for hospitals, administrations, and clinics and that there's a significant positive relationship between measurement and goal congruence.

The studies use a great deal of detail to describe the research purpose, background, methodologies, and conclusions. In many of them there is more description of the research process than the findings. I recommend this book for readers interested in the academic research of the subject material. The findings include real-world applications, and the results apply to readers from various organizational functions (e.g., marketing, operations, human resources) although those from finance and accounting may have more interest in the detailed research and conclusions.—*Lance A. Thompson*

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Accounting Research Bulletin (ARB) No. 51, "Consolidated Financial Statements." The Board says it did this "to expand upon and strengthen existing accounting guidance that addresses when a company should include in its financial statements the assets, liabilities, and activities of another entity." Many variable interest entities have been referred to as special-purpose entities or off-balance-sheet structures, but this applies to a larger population of entities, the Board says.

The objective of the Interpretation, the Board notes, is to improve financial reporting by companies involved with these entities, not to restrict their use. You can download Interpretation No. 46 from the FASB's website at www.fasb.org. ■