streetwise

BY STEPHEN BARLAS, ALFRED KING, PETER LEITNER, CURT VERSCHOOR, KATHY WILLIAMS

[NEWS]

Finance Transformation: Making Progress | Kathy Williams, Editor

IN THE MIDST OF CORPORATE ACCOUNTING SCANDALS, REGULATORY MEASURES such as the Sarbanes-Oxley Act, market fluctuations and shareholder demands, and a still-weak economy, CFOs are forging ahead with efforts to transform the finance department into a real strategic business partner to the rest of the company. They have made progress, but there's still a way to go, according to the results of a recent study by CFO Research Services and Cap Gemini Ernst & Young.

The two groups questioned more than 300 CFOs and other senior financial executives at U.S. companies with more than $500 million in annual revenues and found lots of plans but little funding. Interestingly, the CFOs said it wasn't Sarbanes-Oxley compliance that was spurring them on—it was the desire to become a decision-support area that others in the company would turn to for ideas about how to increase profitability. They said that if they had the decision-support tools in place, they would be well on their way to compliance anyway. The critical compliance issue is being able to assess their financial condition at a moment's notice, not at the end of a month or quarter, and the closest most of them (47%) are to that now is within one week. Another 24% are within two days.

Respondents said that, during the next 18 months, they are going to put measures or technology in place to improve their budgeting and forecasting operations and their internal controls. For example, they're going to develop rolling forecasts, move to standardized and centralized IT systems, improve their driver-based forecasting models, upgrade their business performance management processes and software, and align forecasting responsibility at the level of control and accountability. They will also institute multilevel certification of financial results and create disclosure committees.

Regarding technology, the survey found that the three technologies that yield the greatest savings are underutilized. Right now, only 25% of the respondents use Web-based self-service, 36% have standardized processes and systems, and 38% are leveraging data warehousing.

Other findings that are notable include:

- Not many of the companies are using shared services to improve finance. Only about 33% use shared services for activities such as accounts payable, payroll, and T&E processing. But those who do use shared services report significant savings—between 6% and 20% on average.
- Most companies aren't prepared to comply with

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EARNINGS STATEMENT PRACTICES

Only seven of the *Fortune* 100 meet transparency and clarity in earnings statement practices, according to the results of a recent survey conducted by Hyperion as part of its "Quarterly Report on Quarterly Earnings." Verizon, Target, Microsoft, UnitedHealth Group, FedEx, Caterpillar, and Cisco post a schedule of quarterly earnings and an updated fact sheet to their websites and issue an income statement, a cash flow statement, and a balance sheet concurrently with their quarterly earnings statement, the study found.

According to Hyperion's analysis, 41% of the *Fortune* 100 posted a schedule of earnings report, which is down from 52% the previous quarter, and 44% issued a cash flow statement concurrently with quarterly earnings statements,

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READERS' INPUT

A NEW ACCOUNTING SYSTEM

Alfred King's article about fair value accounting (September 2003) was spot-on, but the topic is symptomatic of a much larger problem.

Financial statements no longer reflect the economic substance of the modern business enterprise. This is because GAAP accounting has matured to the point of diminishing returns such that the usefulness and relevance of financial statements are questioned, if not derided, by sophisticated investors and managers. To prove the point, one need only compare the statistical relationship of GAAP earnings to market value, on one hand, with economic profit and market value, on the other; the latter wins, hands down.

Radical as it may seem, the solution is a new accounting system, rather than endless tinkering with extant methods and rules. This is not unprecedented when in the midst of a global economic paradigm shift, but FASB's tether to cross-interested constituencies suggests only management accountants are best suited to explore this idea.

Consider the last big change in the world economy and its effect on accounting. When the Agrarian Age shifted into the Industrial Age, economic activity comprised the growth and trad-

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[ETHICS]

More Evidence of Better Financial Performance

by Curtis C. Verschoor, CMA, Editor

THE GROWING AWARENESS THAT PUBLIC COMPANIES HAVE RESPONSIBILITIES to more stakeholders than just shareowners has led to a number of efforts to identify companies that truly take their ethical, social, and environmental responsibilities seriously. Investors that have focused their attention on companies believed to be ethically, socially, and environmentally responsible have fueled a rapidly growing investment segment that in 2001 represented more than $2 trillion in professionally managed and socially screened investment portfolios. This represents a 35% increase from 1999.[1]

A persistent myth concerning responsible corporations is that their financial performance lags traditional investment benchmarks. Over the past five years, I have performed research and publicized that of other researchers to demonstrate that, on the contrary, the mean financial performance of a large responsible corporation continues to be better than that of other large companies. Results of my 2003 study show even more convincing evidence that this is true. Responsible corporations generate significantly larger long-term wealth (two to four times more) statistically for their shareowners than the mean of each of the remaining corporations in the S&P 500. This conclusion holds true regardless of what definition of corporate responsibility is used for selection.

The new study compares the long-term financial performance of each of the four available groupings of publicly designated responsible large companies with that of the rest of the companies in the S&P 500. The responsible corporation groups were those companies in the S&P 500 that were: (1) Best Citizens designated by *Business Ethics* magazine, (2) companies in the USA FTSE4Good Index, (3) U.S. companies in the Dow Jones Sustainability Index, and (4) companies whose management has publicly certified the importance of their code of conduct.

The metric used for measuring financial performance was market value added (MVA). This is a concept developed by prominent financial consultants Stern Stewart & Co., who annually publish the financial performance of the 1,000 largest U.S. companies. MVA measures the amount of shareowner wealth created by a company since its inception and is the best measure of value returned to investors. My study used the MVA amount reported for each corporation without any weighting for size.

Using the *Business Ethics* determination of Best Citizens, which is based on information from KLD Analytics, a prominent social research firm, the mean MVA for responsible corporations was nearly three times larger than the mean of the remaining S&P 500 Index companies using information published in 2001, 2002, and 2003. The difference in each year was highly statistically significant, so the probability that these results could be explained by chance was less than 0.1% (one in a thousand).

Best news of all is that the significance of the difference has increased each year. Thus, the mean average percentage dollar market decline for the Best Citizens from the 2001 to the 2003 report was smaller than that for the remaining S&P companies. Although down from 2001, the MVA dollar differ-

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[GOVERNMENT]

Congress Reviews Sarbanes-Oxley

Stephen Barlas, Editor

WHEN HE OPENED HEARINGS ON how the corporate world has adapted to the “Sarbanes-Oxley” (S-O) world, Senate Banking Committee Chairman Richard Shelby (R.-Ala.) didn’t sound as if he had much sympathy for corporate financial executives who have been complaining about the negative impact on corporate decision making of such things as S-O’s provisions requiring a separate report on internal controls within the annual report, on which the SEC published a final rule last May 27. “By requiring companies to adopt regulatory checklists, critics argue that the Act encourages companies to be overly cautious and to focus on procedure and process at the expense of innovative management. I disagree,” Shelby said. “The Act does not penalize risk taking but, rather, promotes transparent and honest business practices.” The Senate Committee’s hearing in early September was the first in a series and featured William H. Donaldson, chairman of the SEC, who didn’t say anything startling. The House Financial Services Committee started its own hearings on S-O later that month.

Renewed Concerns about Corporate Pension Plans

New disclosures about the shakiness of both corporate pension funds and the federal agency mandated to protect workers whose plans go belly-up have prompted at least one new corporate pension disclosure bill. Reps. George Miller (D.-Calif.) and Lloyd Doggett (D.-Texas) introduced legislation to open up corporate 4010 forms—which detail the financial shape of the company’s pension plan—to public scrutiny. Companies don’t have to make those forms available to the public currently.

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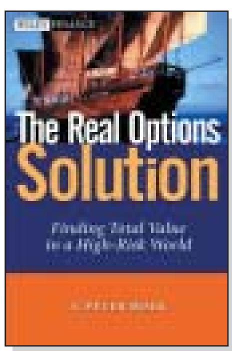
BOOKS

Books on M&A and Real Options

✷ **THE TOPIC OF MERGERS AND ACQUISITIONS** (M&A) certainly isn’t a new one. But while countless books have been written about M&A, most are theoretical; any references to specific transactions usually relate to large publicly reported deals that took place years ago. Russell Robb and Thomas West, the editor-in-chief and publisher, respectively, of the “M&A Today” newsletter, however, are in the trenches every month, putting out their newsletter aimed at M&A professionals. To continue in business, they have to be practical, not theoretical.

In *The Best of the M&A Today Newsletter*, published by Business Brokerage Press, Robb and West have taken 130 of the very best and most useful articles, each highly readable and no more than four or five pages long. Readers of *Strategic Finance* who may only be involved in an occasional transaction could hardly find a better source for obtaining a strong background in the subject prior to getting involved in a specific deal or potential inquiry. Whether your company is likely to be a potential buyer or a potential target, it behooves financial managers to understand how M&A professionals work.



Topics covered include valuation and pricing issues, due diligence, structuring and financing the deal, and even a section on M&A alternatives. For active financial managers dealing with M&A for the first time, this is by far the best book I have seen on the subject. Even if you see no immediate need, get the

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[ETHICS] *cont'd from p. 2*
ence in 2003 was still $10.7 billion in additional wealth created by the average responsible corporation.

The difference between the long-term performance of the FTSE4Good companies and the remaining S&P 500 companies was even more striking. The mean MVA of the responsible companies in 2002 was 3.67 times and in 2003 was 3.33 times that of the remaining S&P companies. The mean dollar additional wealth created by a responsible corporation in 2003 was $10.7 billion. Similarly, the statistical significance of the difference increased for the year, showing that the better performance actually improved. The probability of chance accounting for the results remained less than 0.1% in each year. The U.S. Dow Jones Sustainability Index companies showed a similar comparison.

The study results of companies whose managements publicly certified to the importance of a code of conduct were similar. The mean MVA of a responsible corporation of $31.8 billion reported in 2001 declined by 42.5% by the 2003 report. This was substantially less than the two-year decline of 60.2% from the mean 2001 MVA of $13.3 billion for each of the remaining S&P 500 companies. The mean MVA or wealth created by a company with a commitment to ethics amounted to $13.0 billion on average in 2003, which is 2.45 times the $5.3 billion mean MVA of the remaining companies.

Thus, this new study provides powerful new evidence supporting the belief of many investors that firms that have a strong ethical culture and effectively address social and environmental issues also deliver excellent financial results to their shareowners. Study results are also consistent with the fact that many socially and environmentally managed mutual funds have reported better-than-average results.

The study also casts considerable doubt on the persistent myth that good corporate citizenship tends to lead to additional costs and thus negatively impacts a firm's financial results. Knowledgeable investors should include social and environmental issues as positive factors as they select their investment portfolio.

Corporate management should also recognize the value of the social and ethical measures considered in these rankings when evaluating their own company's performance. ■

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1 Social Investment Forum, *2001 Report on Socially Responsible Investing Trends in the United States*, November 28, 2001. Available at www.socialinvest.org/areas/research/trends/SRI_Trends_Report_2001.pdf. *Abundant Opportunities*, 5th Annual Global CEO Survey, 2003. Available at www.pwcglobal.com.

[GOV'T] *cont'd from p. 3*
Miller had previously introduced legislation mandating changes in corporate accounting for pensions, but that bill has gone nowhere so far.

Miller announced his new bill during hearings in the House Education and the Workforce Committee in September. The hearings heard a new report from the General Accounting Office that put the deficit of the Pension Benefit Guaranty Corporation (PBGC) at $5.7 billion. The PBGC estimates that almost 80% of the 32,000 pension plans offered by single private employers are underfunded. The projected deficit for all of those plans was more than $400 billion as of last year.

"Today's defined benefit system is in a precarious state," said Rep. John Boehner (R.-Ohio), chairman of the Committee. "Though the PBGC has enough resources to make benefit payments for the near future, this poses a serious question of whether a taxpayer bailout of the agency would be necessary if its financial condition continues to deteriorate. It is critically important that we work to prevent another S&L-style bailout that saddles hard-working taxpayers with a tab for billions of dollars."

U.S. Comptroller General David Walker, the head of the GAO, presented the agency's findings, saying that "the long-term viability of the program is at risk." Walker endorsed the new Miller bill in concept and suggested that companies need to pay higher premiums to the PBGC. But Steven Kandarian, executive director of the PBGC, urged caution: "At the same time, we must not create any new disincentives for companies to maintain their pension plans."

The House passed a pension reform bill (H.R. 1000) last May by a vote of 271-157. But the legislation is mainly focused on ensuring that plan participants get good investment advice and that the Enron mistake—where most of the participant accounts consisted of Enron stock—

isn't repeated. There are few provisions on things like disclosure of pension financing or improvements in pension accounting. Miller was unsuccessful in getting those kinds of amendments into the House bill, such as a new accounting standard for issuers of single-employer defined benefit plans so that the plan's investment gains would not be treated as income. ■

[PRACTICES] *cont'd from p. 1*

which is no change from the previous quarter. Then 73% reported a balance sheet with their quarterly earnings statements, up from 68% last quarter, and 61% posted an updated fact sheet.

Other findings: 76% posted corporate governance guidelines, and 96% reported insider filings in either a proxy statement or EDGAR report. Also, it takes the companies an average of 22.15 days to report earnings, with a high of 44 days and a low of eight days. For more information, contact Shev Rush at shev@mediafirstpr.com. ■

[NEWS] *cont'd from p. 1*

some sections of Sarbanes-Oxley. In fact, 67% of the respondents say they still need more than two days to disclose material changes to their financial condition.

- Leading finance functions focus on employee development. The majority of the respondents who say they are well on their way to becoming strategic business partners put significant resources into the training and development of finance employees. Several, for example, rotate finance employees through different business units to give them first-hand knowledge of the operations.

For a copy of the full report, visit www.us.cgey.com/transformfinance.

GASB Issues Report on How to Communicate Performance Information

The Governmental Accounting Standards Board (GASB) recently published a special report, titled *Reporting Performance Information: Suggested Criteria for Effective Communication*, that offers state and local governments a set of suggested criteria for use in developing external reports on performance.

The report is the result of work performed as part of GASB's continuing research project on service efforts and accomplishments (SEA) reporting that is funded, in part, through a Sloan Foundation grant.

It contains 16 criteria that, GASB hopes, will provide guidance that should result in external reports on performance that communicate relevant, reliable information to elected officials, citizens, and other users of the government reports. For a copy, contact the GASB Order Department at (800) 748-0659 or visit www.gasb.org. For additional information on the SEA project, visit www.seagov.org. ■

[BOOKS] *cont'd from p. 3*

book and put it on the shelf. Given the increasing rate of deals, sooner or later almost everyone will need to obtain a quick "How-to" tutorial. And even if you don't have a deal on the horizon, reading these articles will bring alive what you read about every day in *The Wall Street Journal*.

Real Options

The subtitle of F. Peter Boer's book, *The Real Options Solution*, is "Finding Total Value in a High-Risk World," and his objective, while laudable, isn't realized totally. Real options are a developing technique that appears to have a lot of promise. To be useful, however, the practitioner must make a number of difficult, yet key, assumptions, such as the "volatility" of the proposed course of action or investment. This book is a very good introduction to a topic we will continue to read about in the future.—*Alfred M. King, CMA, CFM*

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

ing of food crops and other commodities. Assets had short lives, capital markets were unsophisticated, and firms were very small. Single-entry bookkeeping prevailed until the Industrial Age rendered it useless.

Paccioli's double-entry innovation made it possible to measure the economic value of manufacturing companies, which needed much more capital to finance longer-lived assets than their agrarian forebears. I hasten to add that accounting then, like today, was not merely a scorecard but an essential lubricant for the wheels of commerce. It fostered the emergence of limited liability companies and organized capital markets, which both grew exponentially over the next several hundred years of the Industrial Age, held together by the glue of double-entry accounting.

Our present era, the Information Age, dawned not in the 1990s but in 1955, when white collar and service workers first outnumbered blue collar and production workers in the U.S. As one would expect at the peak of an industrial economy, nearly 80% of the typical, nonfinancial firm's assets were tangible in 1955. Yet by 2001, this measure had fallen to about 50%, reflecting the steady rise of knowledge-based work and the importance of intellectual property, brands, leases, and goodwill as the principal factors of production in the modern firm.

Yet how does one manage or invest in a firm whose key assets aren't fully reflected on a balance sheet, or anywhere else for that matter? Instead of financial statements that clearly and completely present a firm's free cash flow, and thus its economic value, managers and investors must make a series of complex adjustments to financial statements vis-à-vis EVA® or comparable methods. If one must translate financial statements to understand them, then it's time for a new language.

While there are many examples of relevance lost, these three are most obvious:

- Labor, which is traditionally an expense item, is increasingly viewed as "human capital" that we intuitively associate with a balance sheet. GAAP, however, does not except in severances payable, which perversely values knowledge workers only after they're no longer contributing to the firm.
- Capital, traditionally comprising tangible factors of production like plant, property and equipment, has been replaced by leases, R&D, intellectual property, and brands, whose economic substance GAAP generally expenses. And finally,
- Goodwill is the most valuable, elusive, and fickle asset of knowledge-based firms, yet it doesn't appear anywhere on the balance sheet of the firm that it's associated with.

Paccioli gave us a two-dimensional picture of the industrial firm's value, based on one big idea and a few rules to

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1. Paid/requested outside-county mail subscriptions stated on Form 3541.	57,945	56,810
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3. Sales through dealers and carriers, street vendors, counter sales, and other non-USPS paid distribution.	5,962	6,403
4. Other classes mailed through the USPS.		
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1. Outside-county as stated on Form 3541.	1,000	1,000
2. In-county as stated on Form 3541.		
3. Other classes mailed through the USPS.		
e. Free distribution outside the mail		
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g. Total distribution (sum of 15c and 15f)	64,907	64,213
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I certify that all information furnished on this form is true and complete.

Kathy Williams, Editor

[LETTERS] *cont'd from p. 6*

be applied consistently. It served us well, but it's showing signs of irrelevance. We need a new accounting system for the Information Age.

Who else but management accountants are positioned to address this? No one. While the AICPA, FASB, and the SEC quibble over adjustments at the margin, we should wipe the slate clean and design a new accounting system that fulfills the global economy's new requirements for the next two or three centuries.

Peter J. Leitner, CMA, CFM