
SOX

Surviving Sarbanes-Oxley

AND OTHER ACCOUNTING ISSUES

BY RAMONA DZINKOWSKI

While the verdict is still out, the general mood seems to be that corporate America will indeed survive the Sarbanes-Oxley Act (SOX). Although their bruises are still fresh, many companies will emerge more fiscally fit than when they went into this.

In November 2003, more than 800 senior U.S. financial executives gathered at the 22nd Current Financial Reporting Issues Conference of the Financial Executives International (FEI). Not surprisingly, the agenda was heavily weighted toward implementing Sarbanes-Oxley and coming to terms with stock-based compensation. On both fronts, the level of acrimony between the corporate community and the regulatory authorities seems to have subsided somewhat.

ILLUSTRATION: DIGITAL VISION

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In 2002, the Securities & Exchange Commission (SEC) was quite heavy-handed in its position on Sarbanes-Oxley. The same held true for the Financial Accounting Standards Board (FASB) with respect to expensing stock options. One year later, the authorities appeared to be much more calm and even conciliatory! At the same time, senior finance execs seemed rather subdued—or they were just too busy figuring out certification of internal controls to put up much more of a fight.

The executives also discussed current and upcoming FASB, SEC, and International Accounting Standards Board (IASB) projects, recent developments in corporate governance, issues impacting foreign issuers, technical issues surrounding business combinations, transparency in the Management Discussion and Analysis (MD&A) letter, consolidation of variable interest entities, and a view from the Public Company Accounting Oversight Board (PCAOB).

Highlights in a nutshell:

1. The SEC will carry on with even greater scrutiny of company filings and significant changes to the MD&A. With their budgetary windfall from the new congressionally backed funding structure, the SEC will add 100 new sharp accountants to their investigative force.

2. Are the IASB and the FASB at an impasse? Among other things, accounting for derivatives on the balance sheet in Europe threatens to stall convergence of international accounting standards and U.S. GAAP.

3. Companies can expect to use 1% of their human resources complying with SOX Section 404. Meanwhile, auditors' fees could double.

4. More and more companies are turning away from stock-based compensation. If your company continues to offer stock options, however, make sure you have the right option-pricing model.

5. The PCAOB remains firmly behind the spirit of Sarbanes-Oxley, and auditors will do independent testing for control effectiveness to prove it.

SEC UPDATE

Although Sarbanes-Oxley has been put to bed and the SEC is back to other business, governance reform remains central to its mandate. New Chief Accountant Donald Nicolaisen has a single-minded determination to restore confidence in the state of corporate America. He says, "Having spent 36 years in the business community and having seen so many good things, it's extremely depressing to see what's happened over the past three or four years—the state of disarray that the business community is viewed as being in by external parties. There's a need for us to get back to the basics, to restore integrity."

Beyond compliance with SOX, Nicolaisen will be looking for companies to provide a strong tone at the top, tighter controls in areas where temptation is the greatest, and better communication with shareholders and the auditors. He also intends to strengthen communications between the academic community and the business community, the audit profession, and the SEC. For the next year, in addition to stepping up the watch on corporate accounting practices, the SEC will be working on a variety of projects, including the disclosure of companies' contractual payments obligations, reporting off-balance-sheet arrangements, and the use and misuse of non-GAAP measures in annual and interim reports. They will also be emphasizing the information contained in the MD&A and the requirement for more substantive comments from senior management.

FASB AND IASB

The FASB and the IASB outlined their upcoming projects for the year. As the boards press on toward harmonizing U.S. GAAP and International Accounting Standards, the ongoing debate surrounds who should do the changing. To date, there has been some clear give and take on both sides. The IAS is moving closer to U.S. GAAP on certain fronts like assessment of fair market value of assets and liabilities. The IASB appears to be determined to push through fair market value despite considerable opposition from the insurance and banking sectors in Europe. Meanwhile, the FASB is moving closer toward the IASB standards on retrospective application of accounting changes, exchanges of nonmonetary assets using fair value (provided it was measurable and that there was commercial substance to the swap of like kinds of assets), and certain changes in balance-sheet classifications. Finally, harmonizing accounting for business combinations (SFAS No. 141 and IASB ED 3) is a work in progress and is likely to remain high on the priority list going forward.

The main sticking point in harmonization of the two standards centers around macro hedging. While the FASB has agreed to look at an IASB proposal on this front, there's really no incentive for FASB to change its standard. After all, no one really believes that U.S. companies will be denied access to European Union capital markets if they don't reconcile to the local GAAP. Also, the IASB isn't likely to move toward accounting for derivatives SFAS No. 133 style. According to Robert Garnett, IASB board member, "If there isn't a will to recognize derivatives on the balance sheet, which is the view of quite a number of commentators, then I don't see that we can take that project forward for very much longer at all."

SARBANES-OXLEY SECTION 404

Corporate finance officers in America are intensely focused on complying with SOX Sections 302 and 404, and most companies are still in the documentation phase of the requirement of SOX 404. Preliminary results show some of the methodologies that have worked so far, as well as the immediate costs and pitfalls of implementing SOX 404.

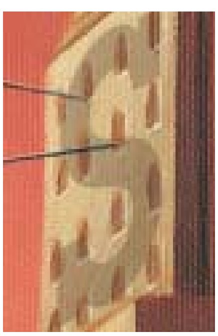
Guidant Corporation is roughly 95% into the documentation process in the U.S. Annette Such, director of Global Accounting Policy and Financial Reporting at Guidant, recommends that companies take a process-owner-driven approach. She says, "Process owners that are working in their area of expertise coupled with financial control awareness training has resulted in greater ownership and commonality at the transaction level." One of the primary concerns Guidant has uncovered surrounding control certification is how to ensure the control environment of outsourced processes like billing, payments, or collections. No advice is available yet on this issue.

Another concern was the cost. Such estimates that complying with SOX 404 will require 1% of their human resources and increase their auditors' fees by 35%. Some think that this is on the low side. According to Raymond Bromark, partner with PricewaterhouseCoopers, auditors are expected to exercise the same level of professional judgment in rendering an opinion on the effectiveness of internal controls as they do on rendering an opinion on the financial statements. From this perspective, fees could be expected to double.

While the companies and auditors were clearly at odds over the size of the increase in fees, both sides agreed that the Enron, WorldCom, and HealthSouth disasters could have been avoided. According to Douglas Carmichael, chief auditor and director of Professional Standards at the PCAOB, none of the things in Sarbanes-Oxley by itself could have prevented the disasters. But he predicts that all the changes at the PCAOB, the SEC, and at the FASB—taken together and diligently implemented—would have gone a long way to preventing them.

STOCK-BASED COMPENSATION

The FASB has concluded that stock-based compensation constitutes payment for services received, so it should be expensed. The main challenge in determining the amount to be expensed lies in estimating the fair market value of the option. A common problem in the option-pricing models in use today is that they weren't designed to



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handle stock-based compensation. More specifically, current models have to be adapted to take into consideration exercise and forfeiture rates. In the end, the evaluation approach used will seriously influence the results obtained.

According to John D. Finnerty, principal at the Analysis Group, the Black-Scholes model, which is the most common option-pricing model used today, tends to overvalue the price of a stock option. Finnerty suggests that Black-Scholes should only be used if it is modified to value nonqualified stock options under certain simplifying assumptions, namely constant stock-price volatility, constant annual proportional exercise rates, constant risk-free interest rates, and a constant exercise price. He also notes that, in addition to these limiting assumptions, another problem is the lack of availability of data with respect to historical exercise and forfeiture rates for comparable companies. He suggests using the binomial option-pricing model instead, which—while still subject to the problem of limited data—adapts more easily to historical exercise and forfeiture rates, can handle dynamic inputs like stock-price volatility, and can handle a richer variety of options than Black-Scholes.

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Compensation trends suggest that the challenges in determining fair value of employee stock options, combined with the potential impact on earnings and the dim view the public has of them, have effectively staved off their use. Frederic W. Cook, founder, Frederic W. Cook & Co., says that companies are being more selective with respect to whom they give stock options and that there's a growing tendency to give restricted or performance-based stock. Cook adds, "There's also some movement toward cash or higher annual incentives, but broad-based grants or employee stock purchase plans are not expected to survive option expensing." He also cautions against using Black-Scholes in converting from options to restricted stock or cash: "If your company substitutes stock options on a dollar-for-dollar value using Black-Scholes, that would be a grave mistake. We advocate a 25% discount in converting Black-Scholes value into dollars or into something else."

PCAOB

One of the highlights was the view from a veteran in corporate governance, William McDonough, former president of the New York Federal Reserve and current chairman of the PCAOB. What could have amounted to a dry rehash of the new reality in corporate governance was eloquently transformed into an inspiring oration. The spirit of his message was: The end is near (for CEO salaries that are bigger than the GDP of some third-world countries)….You must have faith (in the voracious appetite of the auditors to uncover the slightest manipulation in earnings)….You can redeem the wrongdoings of the past (or be prepared to pay the price, which is now exceedingly high).

Despite the polite discourse between the PCAOB and FEI, things may not be as friendly as they appear. The PCAOB isn't on the best of terms with corporate finance officers in the U.S. these days since it has given the green light for auditors to do independent testing of companies' disclosure controls and internal controls for financial reporting. FEI, on behalf of 15,000 senior financial executives, made a die-hard plea against that decision. Yet the PCAOB (and Chairman McDonough) quietly put to rest any wishful thinking on this front while reaffirming the Board's commitment to fully support Sarbanes-Oxley.

The upshot is guarded optimism. Although a little worse for wear, corporate America will survive Sarbanes-Oxley. What remains to be seen in the near future is the overall first-year price tag of SOX (including auditors' fees), the extent to which SOX 404 can be uniformly audited, whether firms can meet their filing dates, whether the new regulatory regime will result in less gaming of the accounting rules, and whether any of this is working to restore investor confidence in financial reporting in America.

Stay tuned. ■

Ramona Dzinkowski is an economist and business journalist in Toronto. You can reach her at rndresearch@interhop.net.