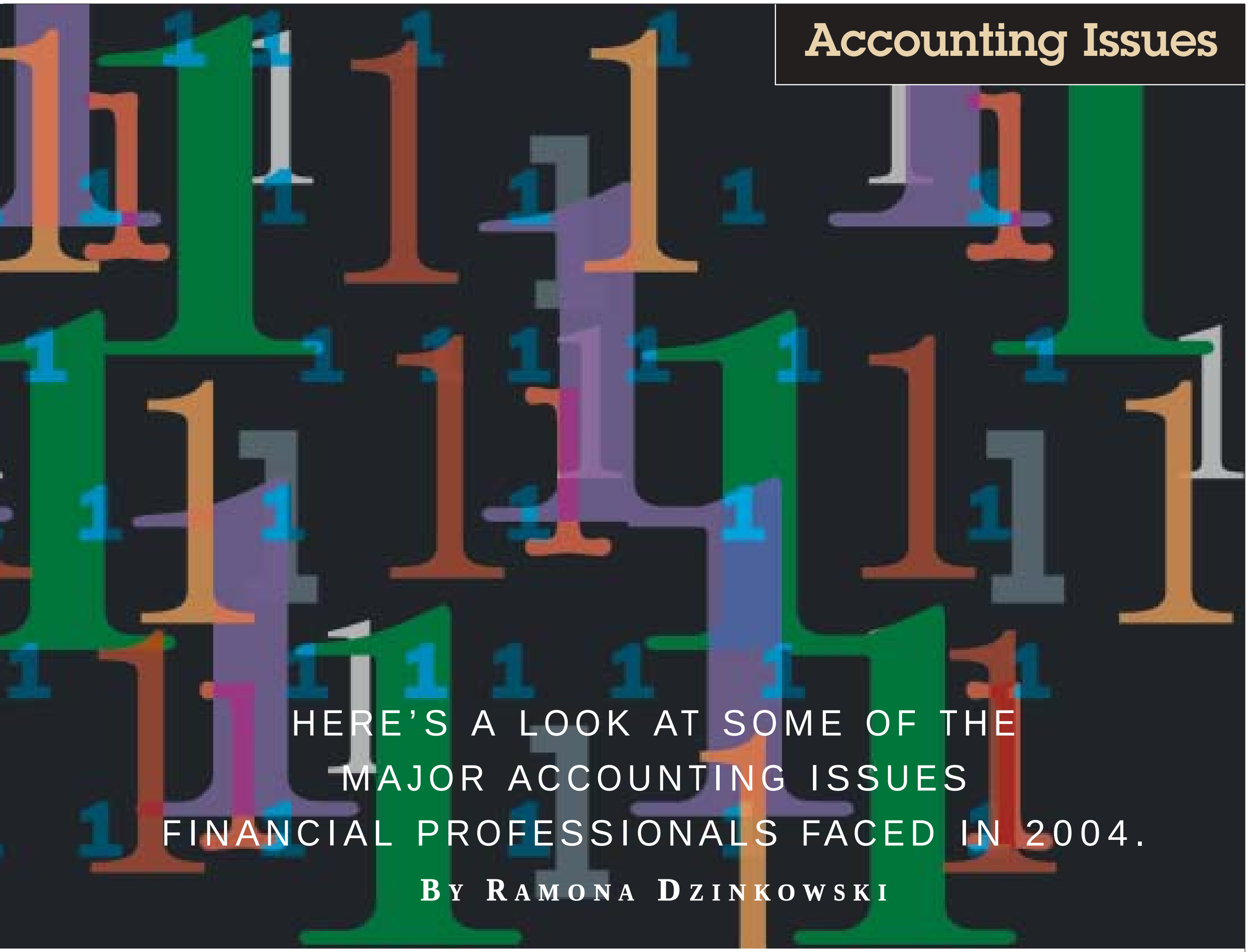
# A Year of Firsts

Last year was a year of firsts for the U.S. corporate accounting community. It saw the first jail terms for senior corporate executives convicted of fraud and other forms of criminal behavior, the first year that the Sarbanes-Oxley Act (SOX) has had a chance to make an impact on investor confidence, and the first year that the Financial Accounting Standards Board (FASB) has made significant moves toward principles-based standard setting.

In November 2004, more than 800 senior U.S. financial executives gathered in New York for the 23rd Current Financial Reporting Issues (CFRI) conference of Financial Executives International. The conference looked back on some of the major events impacting corporate financial management in 2004 and highlighted some important issues that will drive executives' agendas in 2005.

As in the past two years, the CFRI conference addressed the complexities of SOX 404, and now that companies will be filing en masse in 2005, it also focused on specific issues related to fixing material weaknesses in internal control systems. (Some predictions suggest that as many as 20% of registrants could be reporting material weaknesses in their internal controls this year.)

Perhaps with this in mind, the FASB appeared to give the corporate accounting community a break for 2005-2006, putting less emphasis on rule making and more emphasis on other projects. A large part of the FASB agenda in 2005—and potentially for the next three to five years—will focus on codification and convergence projects. The Securities & Exchange Commission (SEC), on the other hand, has stepped up its guidance for increasing transparency in financial reporting, particularly as it relates to the use of non-GAAP measures and the content of the Management Discussion and Analysis (MD&A). As for international accounting standards, the International Accounting Standards Board (IASB) has added pensions



# Accounting Issues

HERE'S A LOOK AT SOME OF THE MAJOR ACCOUNTING ISSUES FINANCIAL PROFESSIONALS FACED IN 2004.

**BY RAMONA DZINKOWSKI**

and intangibles to its "to do" list along with a variety of other joint convergence projects designed to reduce the differences between International Standards for Financial Reporting (ISFR) and U.S. generally accepted accounting principles (GAAP).

## HIGHLIGHTS

**SOX 404.** In the 11th hour, filers were (and some still are) racing to get their SOX 404 effectiveness assessments done and to repair any material weaknesses in their internal control systems. SOX may be driving business decisions in some cases, giving a beginning-of-the-year boost to the IT sector. At the time, auditors were strongly recommending that companies put off until January any purchases of technology that feeds into the internal controls over financial reporting—unless they were absolutely necessary.

**U.S. GAAP.** U.S. GAAP gets an extreme makeover, or at least a face-lift. This year the FASB will be in the development phase of its codification and retrieval project, which effectively promises to rewrite GAAP. The Board's long-term goal is to create a single authoritative codification of U.S. GAAP by integrating existing principles/pronouncements into a single retrievable source.

**Accounting Rules, New and Proposed.** Have a great year! Corporate America will be expensing stock options.

The FASB released Statement of Financial Accounting Standards (SFAS) No. 123 (revised), "Share-Based Payment," in December 2004. The moral of the story for corporate finance executives is choose the option-pricing model that best fits your circumstances. The FASB no longer recommends the binomial model over Black-Scholes. Also keeping U.S. corporate accountants busy in 2005 are "Consolidation of Variable Interest Entities" (FIN 46), "Employers' Disclosures about Pensions and Other Postretirement Benefits" (SFAS No. 132R), and

"Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equities" (SFAS No. 150). Keeping the FASB busy for the next six months are the additional issues of business combinations—purchase method procedures, noncontrolling interests, combinations of not-for-profits, and fair value measurement—and financial instruments—liabilities and equity.

**The SEC Agenda.** The largest 1,000 companies account for roughly 90% of the market cap in the U.S. We can therefore expect the SEC and its sharp new army of accountants to continue to pour over their interim and annual reports. The main message to filers for 2005: Put much more A in the MD&A. Boilerplating won't work anymore.

**Auditing.** The Public Company Accounting Oversight Board (PCAOB) has released Auditing Standard No. 2, "An Audit of Internal Control over Financial Reporting Performed in Conjunction with an Audit of Financial Statements." The auditors also seem to have come to a meeting of the minds regarding the timing of effectiveness testing of internal controls over financial reporting.

## PRINCIPLES-BASED STANDARD SETTING

In the third quarter of 2002, the FASB began discussing the feasibility of adopting a more European, principles-based approach to U.S. standard setting to reduce the level of detail and complexity in accounting standards. At the same time, they established a near-term objective of using identical style and wording in the standards they and the IASB issue on joint projects. Both Boards are currently developing common Exposure Drafts of their proposed statements on accounting for business combinations, among other standards.

Also in the spirit of moving toward a simpler, more principles-based set of accounting standards, the Financial Accounting Foundation's Board of Trustees approved the funding for a massive project that will restructure all U.S. GAAP literature by topic into a single authoritative codification. According to FASB Chairman Robert Herz, "This will entail us to effectively rewrite GAAP. This is going to probably be the largest project that the FASB has ever encountered."

Clearly, the objective of closing the gap between U.S. financial accounting standards (FAS) and International Accounting Standards (IAS) will likely keep both the FASB and the IASB busy for years to come. A caution to the U.S. corporate accounting community going forward: Don't continue to ask for too much guidance in the future. One of the key objectives of the entire exercise is to simplify, which means that the FASB will likely be inclined to provide less written implementation guidance than it has in the past.

## ACCOUNTING STANDARDS CONVERGENCE

What does this mean for achieving one set of accounting standards worldwide? The news just got a whole lot better. We know that the FASB has no intention of throwing the baby out with the bath water. After all, U.S. standards fundamentally have been developed with an underlying accounting principle in mind. But the will is clearly there to make GAAP less rules oriented and more user friendly and to incorporate best practices from the international community.

Meanwhile, measured progress toward convergence between U.S. FAS and IAS presses on. In 2003, uncertainty over expensing stock options and fair market valuation threatened convergence, but now these issues seem to be put to rest for the time being. The FASB and the IASB are basically on the same page when it comes to expensing stock options (reference the release of SFAS No. 123R regarding share-based payments). Whether or not the U.S. Congress has something to say about it remains to be seen.

On fair market valuation—macro hedging in particular—IAS No. 39, "Financial Instruments: Recognition and Measurement," and SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities," have moved closer together. It's now up to the banking and insurance community in the European Union (EU) to comply, or not, as the case may be. This puts the issue into the EU's hands, freeing up the Boards to pursue other convergence projects going forward (revenue recognition, income taxes, pensions, borrowing costs, joint ventures, interim reporting, R&D, and segment reporting).

At the same time, the IASB has its own independent agenda that's moving forward. Specific topics are accounting for insurance contracts; accounting for exploration costs in mining and extractive industries; financial risk disclosure, i.e., the way risks are reported internally and the risks in holding financial instruments; and accounting standards for small and medium-sized enterprises (SMEs).

## DISCLOSURE, DISCLOSURE, DISCLOSURE

If you're thinking of becoming a U.S. filer, here are some things to worry about.

In general, the SEC isn't yet satisfied with the level of disclosure in U.S. public companies. In the words of the top accountant in the land, SEC Chief Accountant Donald Nicolaisen, "Disclose, Disclose, Disclose." More specifically, the SEC is calling for preparers to mind the letter of the law when it comes to Regulation G, the use of non-GAAP financial measures. The Commission is also encouraging senior management to put some meat into the MD&A as opposed to empty reporting on corporate stats. The list of what the SEC will be looking for in the MD&A is intended to reveal the economic story of the firm, namely:

1. Clarify overall presentation, and eliminate duplicative or immaterial information.
2. Involve top-level management in the preparation of the MD&A, present a thoughtful analysis of items affecting the business, and include management's views on these implications and their significance.
3. Provide an executive summary overview in an introductory or overview section in a balanced way. The summary shouldn't simply duplicate information from other sections of the document.
4. Include information relevant to understanding the company's business, even if it isn't explicitly required.
5. Discuss material trends and uncertainties.
6. Enhance liquidity and capital resources disclosures.
7. Enhance critical accounting policy disclosure.

With record increases in the number of accountants on the SEC's payroll, it's quite likely that filers who ignore the above advice will receive a personal note from one of them asking for a better indication of the status of the business—post haste.

## THE NEW ERA OF ACCOUNTABILITY

Again, one of the many highlights of this year's conference was hearing the heartfelt comments of William J. McDonough, the auditor's auditor—PCAOB chairman and former president of the New York Federal Reserve. He never disappoints when it comes to the use of sober symbolism. In his speech on the "New Era of Accountability," he called for a new model for corporate reporting, concluding at one point that "quarterly reporting will be the downfall of capitalism." He also reinforced his disapproval of a system that continues to allow huge pay packages for chief executives of public companies. Says Chairman McDonough in reference to executive compensation: "It's a great economic theory—it's called greed." Finally, while he lauded the accounting and regulatory communities in their efforts to restore investor confidence, he also recognized that "vastly more needs to be done and soon." He emphasized: "What's at stake is the trust of the American people and people around the world—in our markets and in companies like yours."

## CLOSING 2004

In last year's coverage of the CFRI, I left you with a few issues that might come to light by the end of 2004. Here are some preliminary conclusions.

1. **What will the first-year price tag of SOX be?**

**Bigger than expected.** A July 2004 FEI survey of more than 200 U.S. public companies showed that the costs of first-year SOX compliance is estimated to be more than $3 million per company. This is a 62% increase over estimates that were gathered in January 2004.

2. **Will we see better reporting practices and less gaming of the accounting rules in the U.S.?**

**It's possible.** If U.S. GAAP is reworked to reflect "objectives" or principles-based accounting standards and the FASB can resist providing extensive guidance on applying them, then gaming the accounting rules becomes less of an issue. Yet it's up to the corporate community to uphold the principle of the standards. Furthermore, there is one more pair of eyes—the PCAOB—making sure the corporate accounting community behaves. It now has the authority to investigate companies and to report accounting irregularities and deficiencies to the SEC.

3. **How will the investor community respond to Sarbanes-Oxley?**

**Inconclusive.** The benefit of improving transparency and accountability in financial reporting has been offset by other problems. The fact that Marsh & McLennan, the world's largest insurance broker, is being sued for collusion and price fixing certainly hasn't helped to restore confidence in U.S. capital markets. One U.S. investor confidence index puts investor confidence lower today than at any time in the five years prior to SOX.

The FEI conference on corporate reporting closed with a tone of guarded optimism. The worst of Sarbanes-Oxley is seen to be over—in terms of climbing the 404 learning curve anyway—and finance executives are looking forward to getting back to focusing on managing the business. ■

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