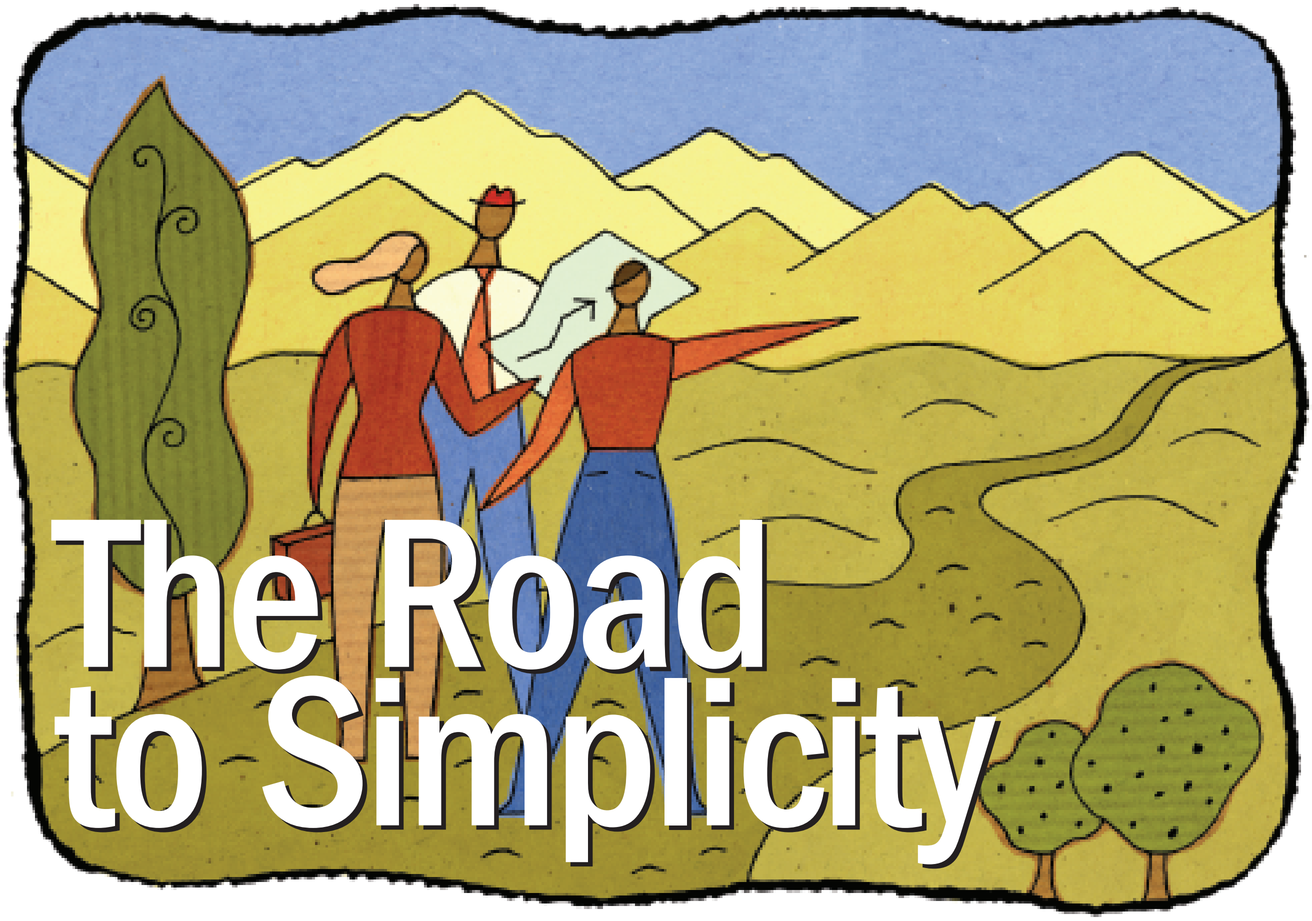

The Road to Simplicity

How much progress have we really made toward less complex accounting regulations?

BY RAMONA DZINKOWSKI

The year 2005 was a year of confusion for the U.S. corporate accounting community. While still coming to terms with what "sustainable SOX" looked like, many companies had to shift their focus back to a host of new and complex financial reporting rules and regulations. At the same time, international convergence of accounting standards was creating uncertainty within the preparer and auditor communities alike. Both were—and still are—concerned about what "principles-based standards" would mean under the current financial accounting and reporting model in the United States.

In November 2005, more than 800 senior U.S. financial executives gathered in New York to discuss these topics at the 24th Current Financial Reporting Issues Conference (CFRI) of Financial Executives International (FEI). The conference looked back at some of the major events impacting corporate financial management in 2005 and highlighted some of the important issues that will drive the accounting agenda in 2006 and beyond.

ECONOMICS 101: BACK TO BASICS

The main message of the conference was that the accounting paradigm in the U.S. has to shift back to its economic fundamentals. Financial Accounting Standards Board Chairman Robert Herz says, "This is an amazingly complex system, and my own view is that something has to be done about it." He adds that the problem with accounting in the U.S. is that it has strayed from its initial intent of describing the underlying economics of the firm: "I would say that part of the complexity around the rules and statutes are that they evolved around issues where accounting doesn't reflect economics.…There are a lot of situations where we know that the accounting is

ILLUSTRATION: IMAGE ZOO

not an actual phenomenon in the business world or the financial world….When you start to converge the economics based on rules and bright lines—accounting that doesn't keep up with the economics—you get all sorts of problems."

SIMPLICITY, TRANSPARENCY, AND IFRS

The FASB insists that its modus operandi now and going forward is to reduce complexity and increase transparency in financial reporting. To this end, it says, it will continue to move toward one internationally accepted, principles-based accounting system—the International Financial Reporting Standards (IFRS).

It is commonly understood throughout the business and regulatory communities that the many diverse accounting standards in countries around the world make it very difficult to compare financial information among companies of different origins. In an era of economic globalization and perfectly mobile information, this lack of harmony has lingered as a reminder of how fast industry has changed over the past 30 years and how slow the accounting community has been to respond to these changes.

From 1973 to 2001, the International Accounting Standards Committee (IASC) attempted to address the problem, with little success. Not until 2001, armed with a new name—the International Accounting Standards Board (IASB)—a new constitution, and a new Trustee Selection Committee, did the IASC's slow and politically painful march toward standards harmonization kick into high gear. This effectively jump-started the harmonization process that we now observe today—a process that's a collaborative venture primarily between the FASB and the U.K.-based IASB. By the end of this year, 100 countries are expected to adopt the IASB's new International Financial Reporting Standards, and another 100 might follow suit within five years.

Observers of the process attribute the relatively fast pace of standards harmonization of late to an unexpected spirit of cooperation between the FASB and the IASB. Many can't help but notice how far the two boards have come over the past four years. Theoretical debates over principles- vs. rules-based standards setting have seemed to subside—on the side of principles.

In the third quarter of 2002, the FASB began discussing the feasibility of adopting a more European, principles-based approach to U.S. standards setting to reduce the level of detail and complexity in accounting standards. At the same time, it established a near-term objective of using identical style and wording in the standards issued by it and the IASB on joint projects.

In looking at the convergence projects to date, a recent CFO study assessed which group was more influential in developing completed standards and predicts who will be taking the lead on projects going forward (see Tim Reason's article, "The Narrowing Gap," in the December 2005 issue of *CFO*). It points to a clear level of cooperation between the two standards setters and a certain level of give and take. According to the report, the IASB was more influential in the areas of share-based payment, inventories, asset exchanges, voluntary changes in accounting policies, insurance contracts, and leasing. The FASB was seen as being more influential in the areas of discounted activities, depreciation on assets held for disposal, and liabilities and equity (currently under development).

> "A principles-based system depends on the willingness and ability of people to exercise judgment. Right now we don't see a lot of that."

At present, the FASB and the IASB are developing common exposure drafts of their proposed Statements on Accounting for business combinations, conceptual framework, reporting on financial performance, and revenue recognition. Also, an exposure draft on fair value reporting has been developed by the Canadian Accounting Standards Board on behalf of the IASB. And in the spirit of moving toward a simpler, more principles-based set of accounting standards, the FASB is proceeding on its massive project that will restructure all U.S. GAAP literature—produced by the AICPA, the Securities & Exchange Commission (SEC), the FASB, and the FASB's Emerging Issues Task Force (EITF)—by topic into a single, authoritative codification.

BUT HOW ARE WE REALLY DOING?

In looking back over 2005, did the FASB's philosophical shift toward principles-based standards help increase the simplicity and transparency in financial reporting in the U.S.? I guess it depends on whom you ask. If we asked the audience of CFOs at the FEI Current Financial Reporting Issues Conference, my bet is that they would say things haven't really gotten a whole lot simpler or clearer.

In 2004, the FASB issued a moratorium on new accounting rules in order to give weary Sarbanes-Oxley Act (SOX) filers a break, but we've seen the impact in 2005 and now into 2006 through a plethora of new standards. From the FASB are Statement of Financial Accounting Standards (SFAS) No. 123R, "Share-Based Payment"; SFAS No. 154, "Accounting Changes and Error Corrections"; and FASB Interpretation (FIN) 47, "Accounting for Conditional Asset Retirement Obligations." In exposure draft are business combinations, servicing rights, convergence, earnings per share, and ongoing implementation activities (income tax projects). Other major projects on the table going forward are a conceptual framework, fair value measurement, liabilities and equity, reporting financial performance, revenue recognition, pensions, and, potentially, lease accounting.

Meanwhile, the SEC has put out new guidance and interpretations on a variety of issues, including stock options, and has stepped up efforts by the Enforcement Division with respect to detecting fraud and scrutinizing corporate governance practices. Major areas of focus are premature revenue recognition, excess reserves to smooth earnings, improper accounting for vendor rebates, improper capitalized costs, changing estimates to "make the numbers," top-side and period-end journal entries, and "earnings management."

Also, there still seems to be a lot of buck passing when it comes to reducing complexity and increasing transparency. The auditors blame their fixation on bright lines and rules on the Public Company Accounting Oversight Board (PCAOB), the SEC, and the lawyers. The SEC is pointing its finger at the fraudsters who are making life miserable for us all. The FASB points to the preparer and audit communities, who are asking for too much guidance. The preparers blame everyone, including the volumes of verbiage that are still being produced by the FASB on certain issues (witness SFAS No. 123R).

Robert Herz notes, "Moving forward toward principles-based accounting standards is very difficult in the face of ongoing requests for increased guidance on specific rules….The constant stream of requests for detailed rules and clarification of this word or that word is unbelievable….A principles-based system depends on the willingness and ability of people to exercise judgment. Right now we don't see a lot of that. We're going to try to move in that direction, but we need the cooperation of both the auditors and preparers and, to a certain extent, the SEC staff who promulgated the idea of principles-based standards. On a day-to-day basis, some of their activities are not necessarily going to be conducive to getting there."

In terms of guidance, perhaps the apple doesn't fall too far from the tree? The FASB consults with three formal advisory councils, the FEI, and the Institute of Management Accountants (IMA®), and it has quarterly meetings with the SEC, PCAOB, banking regulators, more than 20 other formal liaison groups, an investor task force, the valuation resource group, project resources groups, the EITF, and its working groups. It has implementation-issues resource groups, the comment letter process, public roundtables, field visits, and regular meetings with constituents.

Larry J. Salva, senior vice president, chief accountant, and controller of Comcast Corporation, says that while the concept of principles-based standards might be preferable to the current accounting framework, the audit and regulatory communities must allow that to happen. He notes, "With the transition to principles-based standards or objectives-based standards, there has to be objectives-based application of the standards and maybe more room for reasonable judgment in the application of standards, not always one right answer….It's frustrating sometimes that I have a cooperative working relationship with a firm to reach a conclusion, and it's overturned by the staff (SEC)." Furthermore, Salva adds, the main issue keeping chief accountants up at night is "the constant flow of new or increasingly complex regulations, rules, and standards impacting financial reporting and the intense regulatory scrutiny that we're all operating under."

THE ROAD FORWARD

Despite the confusion, the conference closed with a clear message. Although we aren't there yet, the continued cooperation between the IASB and the FASB and the ultimate convergence of U.S. GAAP with IFRS will ensure that international companies have access to the deep and dense U.S. capital markets while holding out the hope for less complex, more transparent, and more user-friendly financial statements in America. Accountants and regulators who are stuck in form, concepts, and financial management practices that don't necessarily reflect the underlying economic reality of the firm will have to revisit the ultimate goal of financial reporting. ■

Ramona Dzinkowski is an economist and business journalist living in Toronto. She is published internationally and has been nominated twice as the Canadian Business Journalist of the Year. You can reach Ramona at rndresearch@interhop.net.