streetwise

BY STEPHEN BARLAS, JEAN-VICTOR CÔTÉ, PAUL L. SHILLAM, LANCE A. THOMPSON, KATHY WILLIAMS

[NEWS]

FASB and ASBJ Discuss Global Convergence | KATHY WILLIAMS

Board and staff members of the Financial Accounting Standards Board (FASB) recently met in Tokyo with representatives of the Accounting Standards Board of Japan (ASBJ) to continue their discussions about global convergence of accounting standards. Led by FASB Chairman Robert Herz and ASBJ Chairman Ikuo Nishikawa, the meeting was the third between the two groups on this topic.

Both Boards have been working with the International Accounting Standards Board (IASB) on various convergence projects and reported on them at the meeting. According to the FASB, ASBJ representatives discussed the current status of their projects and provided analyses of differences among U.S. GAAP, IFRS (International Financial Reporting Standards), and Japanese GAAP. They also discussed projects on segment reporting, intangible assets, and special purpose entities.

FASB representatives reported on their current projects, which include employers' accounting for postretirement benefits (including pensions), financial statement presentation, financial instruments at fair value, leases, and financial instruments: liability and equity, the Board said. The FASB also provided an update on its conceptual framework project, focusing on the redeliberations of the Preliminary Views, *Conceptual Framework for Financial Reporting: Objective of Financial Reporting and Qualitative Characteristics of Decision-Useful Financial Reporting Information*.

Both groups of representatives also exchanged their views on the current status of their work on measurement in the conceptual framework, liabilities and equity, business combinations, and postretirement benefits. They said that these ongoing discussions "are useful in promoting mutual understanding that will contribute to subsequent deliberations at their respective Boards and to their respective convergence projects with the IASB."

Regarding convergence, the FASB says that all three organizations believe that "common global financial reporting across the major business and capital markets of the world is a critical component in providing credible, comparable, conceptually sound, and usable financial information."

For more information about the groups and their projects, visit www.fasb.org or www.asb.or.jp/index_e.php. ■

SEC ISSUES *COMPLIANCEALERT*

The staff of the Securities & Exchange Commission (SEC) issued its first *ComplianceAlert* letter last month to help chief compliance officers of SEC-registered firms learn more about common deficiencies and weaknesses that SEC examiners are finding during compliance examinations. The SEC's Office of Compliance Inspections and Examinations conducts examinations of SEC-registered investment advisers, investment companies, broker-dealers, and transfer agents to determine whether firms are in compliance with federal securities laws and rules and to help correct deficiencies and weaknesses in compliance and supervisory controls.

The letter is available on the SEC website at www.sec.gov/about/offices/ocie/complialert.htm. It summarizes select areas that SEC examiners have recently reviewed during examinations, describes issues that were found, and encourages firms to review compliance in these areas and implement improvements as appropriate. The SEC says that "this broader sharing of recent examination findings can benefit compliance officers and help them to proactively fine-tune their compliance and supervisory controls."

The SEC staff says that it plans to continue to issue *ComplianceAlert* letters on the website. ■

Letters to the Editor

THE ETHICAL ISSUES

I read Curt Verschoor's article in the May issue with extreme interest. While he has done a good job at taking the pharmaceutical firms to task, he could have easily included the medical device manufacturers. I attended an HFMA Supply Chain Strategies Conference last year where one of the presenters outlined the profitability of the various device manufacturers, and, oh what a surprise, they were huge! The average COGS for the group he reviewed was 32%, resulting in a gross margin of 68%! Is there something wrong with THIS picture? I suggest that the medical suppliers—pharmaceutical firms, medical device manufacturers, and others—need to realize that THEY are a big part of the reason that health care costs are exorbitant.

Thanks to him for focusing attention on one industry. It might be worth looking at the ethical issues facing the medical device industry as a follow-on to this important piece.

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We welcome all opinions on articles and departments published in *Strategic Finance*. E-mail correspondence to Kathy Williams at kwilliams@imanet.org.

[GOVERNMENT]

SEC/PCAOB Finalize 404 Guidance

STEPHEN BARLAS, EDITOR

The Securities & Exchange Commission (SEC) and the Public Company Accounting Oversight Board (PCAOB) published their final Sarbanes-Oxley Section 404 changes in late May. Actually, the SEC only published a press release. The actual management guidance wasn't available at the time of the announcement, and key players still hadn't seen it by early June. The SEC guidance is supposed to give corporate managers better instructions on what kind of internal controls to check as well as how to report what their check turns up. The PCAOB's Auditing Standard No. 5 (AS5) tells auditors what they should look for when assessing corporate internal controls and reporting on what they find. "With the Commission's new interpretive guidance for management on the evaluation and assessment of its internal controls over financial reporting, companies of all sizes will be able to scale and tailor their evaluation procedures according to the facts and circumstances. And investors will benefit from reduced compliance costs," said SEC Chairman Christopher Cox.

The business community was underwhelmed by the SEC's final guidance and the PCAOB's AS5. The SEC and PCAOB did very little in regard to scaling down SOX for smaller companies, much less delay management reporting on internal controls, which the SEC had been putting off for small companies. Cox said small companies will have to comply when they do their fiscal 2007 financial statements. Sen. John Kerry (D.-Mass.), chairman of the Senate Small Business and Entrepreneurship Committee, had been pushing for a further delay in small business compliance and was unhappy with the SEC's decision. "I am concerned that the SEC has provided no assurances that the new internal controls rules will actually reduce costs for small public companies because they have not yet completed the required Regulatory Flexibility Act review of the rule," Kerry said. "I am also disappointed that the SEC has not granted small public companies a one-year delay in their filing requirements nor issued a small business compliance guide to assist small firms come up to speed with these new regulations."

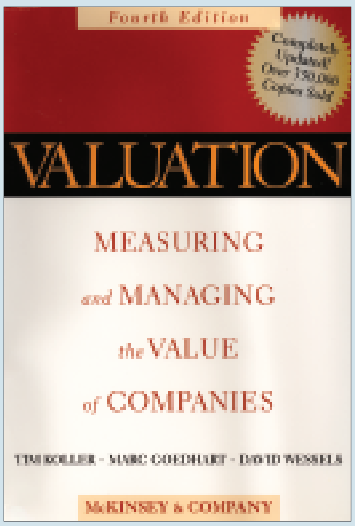
The U.S. Chamber of Commerce is taking a wait-and-see attitude. Michael J. Ryan, Jr., executive director and senior vice president at the Chamber's Center for Capital Markets Competitiveness, describes the SEC's efforts in providing more risk-based and principles-based guidance to management as an improvement but wonders if it's enough. "The answer," he says, "depends first on the clarity of the SEC's guidance and how it is interpreted by the SEC, PCAOB, public companies, and audit firms. In the end, the policymakers in Washington can say all the right things, but what will matter to companies and their shareholders is how this will play out in the field. Only time will truly tell."

The Chamber has been concerned with how continued on page 22

[BOOKS]

Effective Valuation

Future and current managers and investors who want to help their companies create value may be interested in *Valuation: Measuring and Managing the Value of Companies* by Tim Koller, Marc Goedhart, and David Wessels, which was originally developed as a handbook for McKinsey consultants. In it, the authors provide detailed instructions about valuing companies by following the path traced by generations of fundamental analysts, only improved and updated with insights from the latest financial theories and empirical studies.



The emphasis throughout is on actionable insights and sustainability. The authors debunk some well-entrenched misconceptions about value, especially about price earnings multiples, and provide a wealth of advice about valuation pitfalls. They also explain how to communicate with employees and investors about value, and they consistently provide examples from major industries and companies to illustrate their main recommendations.

They begin by presenting the argument that “deviations from intrinsic value tend to be short-lived” in the stock market, backing up the claim by drawing from a wealth of data on the stock market and discussing stock market inefficiencies at length.

Next they describe a model of value creation with three parameters: growth, the return on invested capital (ROIC), and the weighted average cost of capital (WACC). Those parameters can be integrated into at least three well-known valuation models—the discounted cash flow (DCF) model, the economic profit model, and the adjusted present value (APV) model. The authors demonstrate the equivalence between these models and how their parameterization streamlines the forecasting process. For example, the equivalence relation between the DCF and economic profit models provides opportunities to double-check calculations. In particular, the parameterization helps provide reasonable first approximations.

The model is integrated into a conceptual framework for value creation that is analogous to the product life cycle model in marketing. It provides contextual managerial guidelines for each stage of value creation. Linking financial forecasts to economic forecasts is an essential feature of this model (especially the economic profit version of it), as is linking financial drivers of value to operational drivers of performance. The first linkage is to strategy, and the second is to tactics. The discussions about strategy are grounded in managerial economics and include considerations, for instance, about signaling effects and information asymmetry.

Most of the valuation worksheets the authors include have built-in double checks, such as reconciliations between net income and net operating profit less adjusted taxes, free cash flow and cash flow available to investors, and so forth. This proves very useful since financial statements have to be reorganized in order to provide comparable data, which can be an error-prone process. The authors don’t shy away from difficult restatement problems such as operational leases and expensed investment (such as R&D and advertising), employee stock options, various types of provisions, pensions and postretirement medical benefits, minority interest, and inflation. They discuss the valuation implications of such things as hybrid securities and off-balance-sheet financing. And they provide guidance about ranking cash flow estimates according to their order of confidence in order to present incremental valuations instead of scenarios in cases when a decision might depend on the occurrence of a series of progressively more unlikely events.

The discussions of performance measurement and management present a conceptual framework similar in principle to the balanced *continued on page 61*

[RESEARCH]

IMA Issues Statements on Management Accounting

In its efforts to further develop the management accounting body of knowledge, the Institute of Management Accountants (IMA®) develops and publishes *Statements on Management Accounting* (SMAs). SMAs provide practice-based guidance to the global financial community on management accounting and financial management concepts, policies, and techniques. They represent comprehensive summaries of specific "bodies of knowledge" defining competency in management accounting. SMAs are intended to provide value to practitioners, professors, and students.

SMAs cover a wide range of topics relevant to management accounting professionals, including lean enterprise fundamentals, lean accounting, implementing target costing, enterprise risk management, and ethics. New topics, in line with timely issues of the profession, are added on an ongoing basis. Each SMA includes comprehensive resources on the topic, a rationale, definitions, business issues, the role of the management accountant, and, if applicable, case studies and implementation steps or processes.

"Through IMA's *Statements on Management Accounting*, professionals have access to IMA's relevant and growing body of knowledge. The SMAs are accessible, comprehensive, and highlight the issues of the profession," said IMA Director of Research Raef Lawson, CMA, CPA. "We are pleased to provide value to our members by issuing SMAs that deliver practical, actionable knowledge to the management accounting professional."

Authored by management accounting practitioners and academics, SMAs undergo peer review and exposure processes before being published. As part of this process, draft SMAs are made available for viewing and comment at www.imanet.org/sma_exposure_drafts.asp. Public comments are welcome. Once they are final, the SMAs are available for free download at www.imanet.org/smas.

IMA is also currently accepting suggestions for future SMA topics as well as suggestions for authors and reviewers. For more details, please contact Raef Lawson at rlawson@imanet.org. ■

[GOV'T] *cont'd from p. 20*

both the SEC and PCAOB define "materiality," which is a yardstick that companies are supposed to use in testing their internal controls. Hal S. Scott, a Harvard professor and director of the committee on capital markets regulation, which was appointed by Treasury Secretary Henry Paulson, explains, "It does not appear that the SEC has defined 'materiality' with any precision; certainly the PCAOB has not in its proposed revision of AS5. We believe that without a quantitative definition—we suggested 5% of pre-tax income—the costs of 404 will not go down enough."

Waxman Eyeing Compensation Consultants

A number of state pension funds are pushing congressional Democrats to consider barring compensation consultants who advise corporate boards on pay for top corporate executives from getting contracts for other services from the company's managers. The state funds and groups like the Council of Institutional Investors (CII) believe there is a quid pro quo going on where the consultants recommend higher pay in the hopes of getting lucrative consulting contracts. When the SEC considered its new executive compensation reporting rules, Denise Nappier, the State Treasurer for Connecticut, had asked for the SEC to require corporate reporting on compensation consultant fees. The agency declined to do so. Nappier described such reporting as an interim step prior to a ban. Fast forward to May 8, 2007, when Rep. Henry Waxman (D.-Calif.) announced an investigation of compensation consultants. Based on what Waxman finds, he may push for legislation paralleling what the SEC did itself in 2000 with regard to "independence" rules for accountants—rules that Congress strengthened in SOX. ■

[CERTIFICATION]

ICMA Offers Chinese-Language Version of CMA Exam

The Institute of Certified Management Accountants (ICMA®), the certification division of the Institute of Management Accountants (IMA®), began offering the CMA® exam in Simplified Chinese this month. The translation marks the first time that the CMA test has been available in a language other than English. The decision to translate the exam reflects IMA's mission of advancing the management accounting profession globally.

"The Chinese economy is expanding exponentially, and in order for companies and professionals to compete successfully, they need solid expertise in decision support, planning, and control," Dennis Whitney, CMA, CFM, vice president of ICMA, says. "The CMA certification is a globally recognized credential for management accountants across all industries. We're pleased to offer the CMA exam in Simplified Chinese to help build the capabilities of professionals in that country."

ICMA saw the need to offer the CMA exam in Chinese partly because of the shifting structure of the Chinese economy and workforce and the growing need for properly trained management accountants. Whereas multinationals once dominated the Chinese market landscape, China-based enterprises are now gradually gaining market share. Although the English CMA exam has been available in the People's Republic of China for many years, many management accountants working at smaller or even state-owned organizations may not be fluent enough in English to take the exam successfully.

Jim Gurowka, IMA international development leader, explains: "Except for individuals working at multinationals, the ability to express themselves in English has limited many finance professionals from obtaining their CMA certification, even though they may be well seasoned in their profession. We believe that language shouldn't be a barrier to becoming certified, and we are supporting these professionals by offering the CMA exam in their native language."

Meticulous care was taken to ensure the quality of the translation, which took about one year to complete. A team of ICMA staff and professional translators worked on the subject-matter translation, which was reviewed by a native-born Chinese CMA. After the entire exam was translated into Chinese, it was then back-translated into English for accuracy.

As a result, the Chinese version of the exam is virtually identical to the English version. The same passing score applies for the Chinese exam, and candidates must comply with the same experience, education, and ethical requirements as those who take the English version.

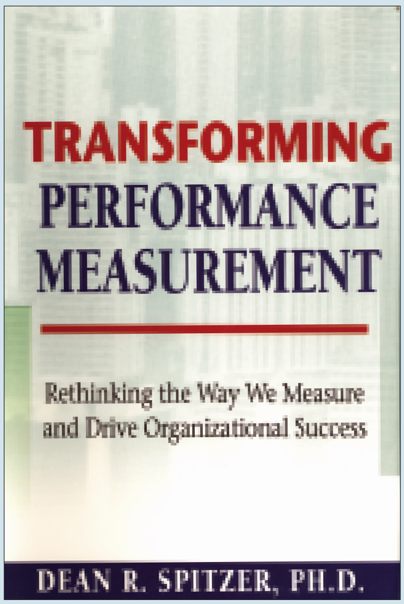
To assist candidates who have registered or are considering taking the exam, IMA is also translating relevant study and support materials into Chinese, including the CMA Resource Guide, the CMA Learning System, and portions of the IMA website. For more information, visit www.imanet.org/certification. ■

[MORE BOOKS]

Measuring to Improve Performance

In *Transforming Performance Measurement: Rethinking the Way We Measure and Drive Organizational Success*, Dean Spitzer describes how the key to organizational success is measurement. When it is done properly, measurement can transform an organization, and it is fundamental to high performance, improvement, and ultimate success in business.

Spitzer focuses on creating an optimal environment (or context) for effective measurement. The real challenge is to improve the social and organizational context in order to make measurement enjoyable and productive for everyone in the organization. Transformational performance measurement involves constant learning. It is about perception, understanding, and insight.



Management needs to focus on the measures that really drive the company's performance and competitive differences. The right measures can have a positive and transformational impact on the way people view their work, products, and customers. The important drivers of value are mostly intangible, such as innovation, customer/supplier relationships, brands, employee talent, intellectual capital, etc. Intangible assets present an opportunity for better measurement, which enables them to be managed better.

Spitzer identifies four keys to transforming performance measurement:

1. Context: Measurement is perceived positively by employees and influences how they emotionally respond to it.

2. Focus: Concentrate on the critical few transformational measures that will make a real difference to competitive advantage, differentiation, and success of the organization.

3. Integration: Measures are to be aligned with strategy and then integrated across the entire organization and extended enterprise.

4. Interactivity: Ongoing interactions and dialogues in the measurement socialization process lead to new insights about what to measure and how to measure it.

Spitzer also provides the "Transformational Measurement Maturity Assessment" for a quick assessment of an organization's need for transforming performance measurement. This helps organizations accelerate their transformation to higher levels of maturity. The maturity of the four keys to transforming performance measurement is assessed against these desired outputs:

1. Context: a culture of positive experience and attitudes

2. Focus: use of high-leverage measures

3. Integration: progress toward a single, integrated measurement system

4. Interactivity: increased speed and quality of conversion of data into insight and action

There are 34 "Transformational Measurement Action Plans" that describe new emergent and transformational measures that should be considered for an organization. These include measures such as customer experience/relationship, intellectual capital, innovation climate, organizational trust, agility, employee engagement, and learning effectiveness.

A common fallacy is that a perfect performance measurement system exists and can be implemented with minimal organizational involvement. Performance measurement systems are effective only when measurement data is being used and converted into insight, knowledge, and wisdom. Most performance measurement challenges are more about culture than technology.

The key thesis of Spitzer's book is that performance measurement will never be transformational without the inclusion of a strong social component. Very few organizations have established a social or organizational context that is sufficient to support their technical measurement system components. The effective business then becomes an organization that questions more, dialogues more, and is more focused on learning.

Spitzer suggests that organizations begin with two basic measurement questions:

1. How should we measure success as an organization?

2. How can we maximize the likelihood, on a continuing basis, that everyone in the organization is working together most synergistically to realize the most important common measures of success?

Transforming Performance Measurement isn't a traditional book on performance measurement and technology solutions. It is recommended for all business management with a need to be more successful, competitive, and aligned as an entire enterprise. Spitzer presents an effective methodology and roadmap that can promote alignment with business strategy, improve cross-functional integration, and help employee teams work collaboratively to drive value and success throughout your organization.—*Lance A. Thompson, Thompson Management Consulting Services, LLC, lancephx@aol.com*

[TAXES] *cont'd from p. 14*

in a 50% reduction (using the exemption rules). In this case, the refundable amount is reduced to $95,000. After offsetting the tax liability, the result is an overpayment of $55,000.

A Compromise Solution

While not a perfect solution, the law is now attempting to address an issue that has proved troublesome to taxpayers who receive an ISO as part of their compensation. A preferable solution for taxpayers would have been to allow an offset (amended return) to the return for the year of exercise. This would allow an immediate refund of the amount paid in as AMT. Another preferable solution would have been to retroactively remove the AMT adjustment on exercise of an ISO. This also would have allowed an amended return opportunity to recover the AMT paid. The credit solution appears to represent a compromise between rectifying an unfair situation and making any loss in revenue to the government prospective rather than immediately refundable. ■

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[ETHICS] *cont'd from p. 16*

harder to differentiate between acceptable and unacceptable teamwork at the university level.

The message learned in the real business world, usually well before a student even applies to a graduate business school, is that cutthroat competition is absolutely required to obtain competitive advantage. In business, the ability to utilize (i.e., steal) someone else's intellectual property by whatever means is welcomed and rewarded. The most confusing example of individual student assessment (i.e., grading) in a collegiate world of collaboration was provided by Stanford University Design School Professor Robert I. Sutton: "If you found somebody to help you write a group project, in our view that's a sign of an inventive team member who gets stuff done. If you found someone to do work for free who was committed to open source, we'd say, 'Wow, that was smart.'"

Question for Readers

Is it really part of the mandate of the educational system to prepare students to behave ethically in the business world? If so, where should this outcome be required: elementary school, middle school, high school, undergraduate, or graduate? ■

Note: Please share your thoughts with me at my e-mail address below.

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[BOOKS] *cont'd from p. 21*

scorecard but with more specific guidance about operational drivers directly related to growth and ROIC. A chapter on valuing mergers and acquisitions (emphasizing synergies) and another on valuing divestitures (detailing transaction types) add a new dimension in value management: the active management of a portfolio of businesses increases value.

The authors use the last section of their book to address special cases, including valuing multi-business companies through the tricky deconsolidation of financial statements, valuing flexibility using either decision trees or real options, cross-border valuation (in spite of accounting and tax differences), valuation in emerging markets (from the perspective of an international investor), valuing high-growth companies (picturing a plausible future and looking back), valuing cyclical companies (giving equal weight to the repetition of the cycle and the start of a new trend), and, finally, valuing financial institutions such as banks and insurance companies.

The authors recommend triangulation of results in order to improve the accuracy. They demonstrate useful equivalences between decision tree analysis and real option valuation when nondiversifiable risk isn't great enough that it would change the investment decision; modeling risks explicitly in the cash flow projections and adding a country risk premium in the discount rate; and three ways to compute equity cash flows for the valuation of financial companies.

The presentation of statistics and accounting is commendable. Their prose is crisp and clear, their argumentation is bulletproof, and their exhibits are very well designed. Their book is an engrossing read for anyone with a background and interest in corporate finance.—*Jean-Victor Côté, CMA, jean-v.cote@sympatico.ca*