Moving Forward, Echoes of 2007

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This January brings with it a time for changes in the world of finance and accounting—a time for renewal and to move forward. Again. Yes, I said something similar in a "Top Line" article last January. Since then, we *have* experienced some change, and many of the changes have been extremely encouraging.

On SOX

Take the Sarbanes-Oxley Act of 2002 (SOX). In spring 2007, the Securities & Exchange Commission (SEC) recognized what we at the Institute of Management Accountants (IMA®) had been saying for more than a year—that American filers needed a different SOX 404 regime. In May, the Public Company Accounting Oversight Board (PCAOB) withdrew Auditing Standard No. 2 and replaced it with Auditing Standard No. 5. That same month, the SEC issued its "Guidance Regarding Management's Report on Internal Control over Financial Reporting."

In addition, IMA continued to call for further deferral of Section 404 applicability to smaller, nonaccelerated filers. Leading politicians also announced that SOX reform was a priority, and, since January 2007, a series of proposed reforms and rejections has been bouncing around.

In November, despite recent proposed reforms, a survey released by the U.S. Chamber of Commerce Center for Capital Markets Competitiveness, in cooperation with IMA and the American Stock Exchange, confirmed that SOX Section 404 burdens small businesses disproportionately. The survey, called Cost of SOX, also revealed that more than half the respondents believe that SOX 404 won't help detect and prevent fraud.

These results illustrate a dismal and discouraging reality for American businesses, and the anticipated benefits related to the reforms created by management guidance and AS5 have done little to change this outlook.

In order for the government to get the necessary and scalable SOX 404 reform right, IMA, the U.S. Chamber of Commerce, and several other professional organizations have called for a one-year delay in SOX 404 implementation for small businesses. In December 2007, SEC Chairman Chris Cox advised the House of Representatives Small Business Full Committee Hearing that he intended to propose to the SEC a one-year delay for the new reporting requirements for small businesses mandated under Section 404(b).

IMA supports Chairman Cox's proposal, but we believe that other issues remain:

◆ There are still no fundamental, systematic changes to create a practical implementation framework for small businesses. Management guidance is vague and not truly risk based for cost-effective implementation.

◆ Since there is no practical implementation framework, small businesses will have to rely on consultants and other third parties.

◆ The SEC's focus on lowering costs is reasonable, but there's no mention of improving restatement rates or the analysis that would predict, with some reliability, that there might be errors.

◆ This delay for small businesses actually creates a two-year time gap in which management (e.g., CEOs, CFOs, and audit committees) is solely responsible for opining on controls effectiveness, creating potential legal liability.

IMA also has reservations about the SEC Office of Economic Analysis Cost-Benefit Survey mentioned in Chairman Cox's proposal. At this stage of SOX 404(a) implementation, small business managers will lack sophistication and experience to adequately quantify compliance costs and benefits in their first year of implementation. IMA recommends that the SEC use best practices from the business community to quantify costs and benefits (e.g., process analysis, simulation modeling, etc.)

On Accounting Standards

Last summer the SEC created a new committee, known as the Advisory Committee on Improvements to Financial Reporting (CIFR). Led by Robert C. Pozen, it drew on senior members representing all aspects of the accountancy and investment community. The Committee created four subcommittees to address different aspects of the woes of finance and accounting conditions in the U.S.: (1) Substantive Complexity, (2) Standard Setting, (3) Audit Process and Compliance, and (4) Delivering Financial Information.

Of particular interest to IMA is the work of the Standard Setting Subcommittee because they invited IMA to brief them on our views on standards setting. We applaud the Subcommittee for its efforts to reconstitute our institutions to be more representative of the entire financial information supply chain. We urge it to propose increased preparer involvement early in the standards-setting process using the engineering profession's best practices. But we have doubts about the continued call for more user involvement. After all, they are way more concerned about future cash flows from effective and efficient business than they are about historical results. Field trials for proposed standards to ensure that practitioners are actually able to implement new standards in a practical and cost-effective way will be really helpful. We commented to the Subcommittee about the recommendation from IMA's Financial Reporting Committee to set up an "accounting court" in order to bring transparency to the SEC's otherwise closed review and decision-making process. Finally we support the Subcommittee's call for more principles-based standards and greater dependence on "professional judgment." This opens up the entire U.S. accounting mode of operating to a less heavy-handed, compliance-oriented approach.

Central to our observations are concerns that American competitiveness is impaired by complex accounting regulations and standards so that U.S. corporations incur more compliance costs than those in other countries. These costs range from excessive audit, legal, and consulting fees to distraction of senior executives from doing value-adding, profit-generating work. IMA called for recognition that the best way to obtain reliable, robust, high-quality financial reports is by making sure that corporate America has properly educated and certified finance and accounting professionals who work inside corporations, building quality processes, procedures, and practices. In other words, by "building quality in."

On December 6, 2007, in my address to the Subcommittee, I also stated that the quality of financial information as measured by the number of restatements is impacted by two primary drivers. The first is the accounting standards themselves, which prescribe how the accounting should be done. Writing implementable standards would be a clear enabler of reducing complexity. The second is the underlying system of controls that ensures that the accounting is done right. At present, the complete lack of prescriptive internal control standards for corporations has created the situation where Auditing Standard No. 5 establishes de facto expectations premised on audit-centric constructs that are highly inefficient and costly. This is clearly an unanticipated consequence of present regulations. In addition, we called for focus by issuers, their external auditors, and the PCAOB on the need to systematically record, track, and analyze errors detected in financial statements and internal control assessment opinions and to report them so that everyone can learn from them. Of course, this would need to be done to ensure further legal liability would be avoided.

An End to Reconciliation: IFRS and GAAP

In November, the SEC voted unanimously to drop the requirement for foreign private issuers to reconcile financial statements to U.S. Generally Accepted Accounting Principles (GAAP) rules developed by the Financial Accounting Standards Board (FASB). IMA has been a strong supporter of this move, and our Financial Reporting Committee had written to the SEC, urging them to adopt this position. The ruling will allow foreign companies to do business in the U.S. under current International

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Financial Reporting Standards (IFRS) developed by the International Accounting Standards Board (IASB).

The elimination of the reconciliation requirement is the first great step by American regulators to ease the burden of complexity on preparers of financial statements. Since 1973, GAAP standards have morphed into more than 10,000 pages of pronouncements and hundreds of thousands of pages of interpretation. Ultimately, the convergence of IFRS and GAAP into a single worldwide set of accounting rules should reduce the amount of labor put into financial reporting and begin to make financial standards understandable and implementable by a much greater proportion of the finance and accounting community.

Only when the most efficient regulatory environment is in place will American businesses be able to compete most effectively in the global market.

Simplification Works

This brings us back to what I have been saying all along: Simplifying regulation works for the public good. By decreasing the burden on corporations, we are recognizing the most important public interest—the creation of jobs and wealth for all of society.

In 2008, we need to move further in the direction already initiated by Chairman Cox and the SEC. We need to reduce the burden of costly, inefficient compliance practices. Only when the most efficient regulatory environment is in place will American businesses be able to compete most effectively in the global market. Central to business competitiveness are the practices of continuous improvement and cost reduction that should be applied to standards, regulations, and their use. Such practices may be contrary to the perceived interests of lawmakers, standards setters, lawyers, and auditors. But their heavy-handed success in weighing down corporate America carries the cost of reducing competitiveness at a time when other economies around the world are taking off without such heavy burdens.

Clearly, the Enron and WorldCom scandals were a wake-up call to lawmakers. What our leaders in Washington need to avoid is causing one problem while solving another. At IMA, we urge the SEC and Congress to make one of their New Year's resolutions a firm commitment to stimulating the growth of all businesses, small and large, within the global market. Focus on the creation of jobs and wealth by reducing inefficient standards and regulations and costly dependence on ineffective assessment and enforcement methods.

We need to shift the emphasis toward empowered business professionals whose judgment is respected as long as they have accomplished appropriate education, certification, and experience. The mantra should be "build quality in," just like that of the Japanese 30 years ago when they completely changed business operating rules globally. Of course they got the idea from the U.S. and applied it in their factories, while American companies were unwilling to change until it was too late. I hope we can avoid making that mistake again. Bring on change, Chairman Cox. This is your year to do it. ■