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By Stephen Barlas, Noah Barsky, Heather Kaminski

GOVERNMENT

Derivative “Margining” Costs Challenged

By Stephen Barlas

The failure of the last Congress to pass legislation to ease concerns for business end-users of derivatives makes the passing of those languishing bills, certain to be reintroduced in the 113th Congress, more critical than ever. The Federal Reserve and its compatriot banking agencies are much closer to publishing a final rule under the Dodd-Frank Act determining when commercial end-users of derivatives must post margin with their banks for derivatives that aren’t being cleared centrally. A bill that would’ve narrowed margin requirements—“The Business Risk Mitigation and Price Stabilization Act of 2012” (H.R. 2682)—passed the House by a 370-24 vote but never made it through the Senate. It never even got a hearing, for that matter.

Representative Michael Grimm (R.-N.Y.), the chief sponsor of H.R. 2682, will reintroduce the bill in 2013. It passed the House handily in 2012 with strong bipartisan support. It’s likely that the Senate never considered the bill because the Obama Administration was dead set against any legislation modifying Dodd-Frank prior to the presidential election.

Whether or not the Obama Administration changes its stance, H.R. 2682 still faces a difficult time in the Senate, not the least because of the emergence of a new voice arguing business groups are crying wolf when they say margin requirements will result in new, heavy corporate financing costs. That new voice is John Parsons, senior lecturer in finance at MIT’s Sloan School of Management and executive director at MIT’s Center for Energy and Environmental Policy Research, who gave testimony to the U.S. House Financial Services Committee in mid-December 2012. This was the first time an opponent of the Coalition of Derivatives End-Users testified to a Congressional committee.

Parsons was critical of a study cited by the Coalition and conducted by Keybridge Research in April 2010. The Coalition has been using the study to show that nonfinancial *Fortune* 1,000 companies would face heavy additional capital costs if they have to margin derivatives. Parsons said, “The study’s estimated cost of margining is entirely a consequence of this fallacious assumption.” He based that statement on the fact that “the cost of the credit risk embedded in a non-margined derivative is equal to the cost of the credit line needed to fund the margin on a derivative.”

Michael Bopp, the counsel to the Coalition, agrees with the premise of Parsons’s analysis but not its conclusion. His reasoning is that, if corporate counterparties pay the same approximate amount to their banks whether it’s in the form of margin costs or credit risk costs built into the price of the derivative, why force banks to demand margin?

New Standard Earns Critics

There were at least a couple of unhappy campers when the Securities & Exchange Commission (SEC) approved the Public Company Accounting Oversight Board’s (PCAOB) Auditing Standard No. 16 (AS No. 16), “Communications with Audit Committees,” in late December 2012. AS No. 16 supersedes the PCAOB’s interim auditing standard AU Section 380, “Communication with Audit Committees,” and Interim Auditing Standard AU Section 310, “Appointment of the Independent Auditor.” AS No. 16 incorporates SEC auditor

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communication requirements set forth in Rule 2-07 of Regulation S-X, "Communication with Audit Committees."

Tom Quaadman, vice president of the Center for Capital Markets Competitiveness at the U.S. Chamber of Commerce, had pressed the SEC, which has the authority to amend PCAOB standards, to exempt "emerging growth companies" (EGCs) from the reach of the Standard. EGCs are a new category of companies for regulatory purposes created by Congress when it passed the Jumpstart Our Business Startup (JOBS) Act in March 2012. EGCs are companies with revenues of less than $1 billion and whose public float (i.e., the value of their stock held by public investors who aren't affiliates) stays less than $700 million. The JOBS Act, according to Quaadman, provides an automatic exemption for EGCs from all new PCAOB rules unless the SEC makes an explicit contrary determination. The SEC did find it "necessary or appropriate in the public interest" to subject the EGCs to AS No. 16, which means Quaadman and the Chamber lost that fight.

Howard B. Levy, senior principal and director of technical services at Piercy Bowler Taylor & Kern, was another unlucky businessman. He argued (and other accounting industry leading lights made similar arguments to the PCAOB) that there were some financial reporting issues on which management should directly communicate with the audit committee and that those issues shouldn't depend on whether the outside auditor brought them up. The SEC argued that it had already made clear when it adopted Rule 2-07 (having to do with auditor independence) that management has the primary responsibility to send some types of accounting information related to financial statements to the audit committee. Moreover, and perhaps more significantly, the PCAOB doesn't have the authority to require management to communicate to the audit committee.

LETTERS

Middle East Salary Survey

I commend IMA's commitment to broadening the global reach and perspective of *Strategic Finance*. However, the second "IMA® Middle East Salary Survey" (November 2012) inexplicably again failed to include the most modern, thriving, capitalist economy in the region—Israel. This tiny nation with a population smaller than the state of New Jersey was characterized by the international Organisation for Economic Co-operation and Development (OECD) as having "produced outstanding (technological and scientific) outcomes on a world scale." Remarkably, among its many innovations and accomplishments in a perilous region of the world, Israel's central bank was rated "most efficient" by Swiss business school IMD, and it ranks second of all foreign nations in the number of companies publicly listed on U.S. stock exchanges. Its economy, in the midst of global recession, produces results that would be the envy of most industrialized nations. Therefore, it seems quite likely that opportunities abound for management accountants and other financial professionals.

While this important compensation survey's second iteration increased distribution by approximately 70% to over 7,500 members, it is quite disheartening to see that the selected nations set was not expanded to include Israel. In *Strategic Finance*'s Letters section in November 2010, Professor Lawson explained the surprising omission of Israel from the initial Middle East survey as "an oversight." Perhaps it is greater oversight of future research that is needed to ensure that readers gain the most complete insights and proper compensation benchmarks about professional work in the Middle East.

—Noah Barsky, Ph.D., CMA, CPA,
Villanova School of Business

Author's Note:

Thanks very much for your letter and for the reminder about including Israel in the sample. While this is an excellent suggestion, it turns out that the sample size of members there would not be large enough to be statistically valid and protect member confidentiality. We hope that this will become an annual survey and that we will be able to include members in Israel in the future.

—Raef Lawson, Ph.D., CMA, CPA, CFA
IMA Vice President of Research and Professor-in-Residence

BOOKS

Successful Performance Improvement

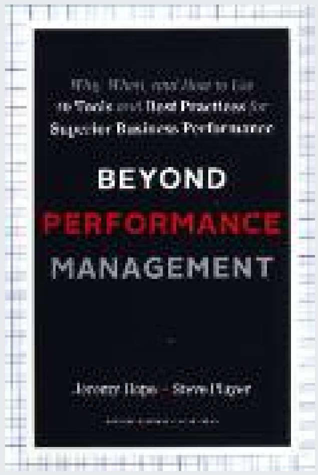
According to research by Harvard professor John Kotter, only 30% of change programs introduced by companies actually succeed. Thus begins the impetus for us to learn from Steve Player and Jeremy Hope's book, *Beyond Performance Management*.

Player and Hope have set their book up topically, allowing the reader to choose which area to reference without having to read straight through—a bonus for busy practitioners. There are 40 mini-chapters divided into five main perspectives: strategic planning, shareholder and customer value, lean cost management, performance management, and performance evaluation. Each chapter is approximately 8-10 pages long and answers these basic questions:

- What is this practice, and how effective is it?
- What is the performance potential of this practice?
- What actions do you need to take (or avoid) to maximize the potential of this practice?

Interspersed throughout each chapter are examples of the specific performance management practice. The chapters end with a conclusion and a useful list of suggested further readings if you want to delve deeper into the particular subject introduced.

One topic covered that I've been long interested in is the concept of lean accounting. The subject is introduced succinctly with an overview of the history of costing within corporations. The authors supply compelling reasons as to why a firm would want to reevaluate overhead allocations—lean manufacturers are more interested in eliminating overheads than finding a way to allocate them. An example of a weekly box report (divided into production, capacity, and financial data) gives a clear picture of what lean manufacturers are looking to share with all employees in order to help improve performance.



The authors note that, while lean accounting is appealling, it hasn't found widespread acceptance or implementation in practice. Wiremold, a U.S. company, is cited as a lean accounting success story. It achieved dramatic growth in assets, gross profit, and sales per employee with substantial decreases in throughput time, the number of suppliers, and product development time over a 10-year period. But in 2000, Wiremold was sold to a French company that dismantled the lean infrastructure.

Player and Hope write that lean accounting supports lean manufacturing, provides more relevant cost accounting information to managers, and simplifies mainstream accounting. Under Actions to Avoid, they caution to not replace standard costing immediately but to slowly implement a parallel value stream costing system and slowly phase out standard costs. Designing and using easy-to-understand reports; reducing inventories by purchasing what's needed, when needed; and using price-led target costing are all identified as actions to take.

Most managers will find several topics relevant to their work. Examples include dynamic resource management, sustainability, economic value added, strategic and profitable customers, target costing, outsourcing and offshoring, business intelligence, and executive compensation. Readers should heed the authors' caution that performance management tools such as the balanced scorecard, benchmarking, and customer relationship management applications often suffer due to ineffective leadership, lack of commitment, and poor implementation. Player and Hope look to circumvent failure by critically reviewing "a wide range of management tools and provide a number of guidelines that will help leaders select the right ones, implement them in the right way, and gain maximum value for their use."

—Heather Kaminski, CMA,
heather.kaminski@snc.edu