Rewriting the Rules

<u>Everything you thought you knew about accounting is about to change. Is there any reason to smile?</u>

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This is the third of a three-part series examining the state of accounting five years after passage of the Sarbanes-Oxley Act.

Now the hard part begins. Five years after the Sarbanes-Oxley Act was passed, its raison d'être — to improve corporate transparency and thus boost investor confidence — has been realized, at least to a degree. Debates still rage about how much credit the act can claim for Wall Street's (pre-subprime) rebound, and, more fiercely, about the cost/benefit equation, but companies have largely made their peace with the act's major requirements, and many agree that its impact has been positive.

But any hope for a respite is misplaced. Most publicly traded companies may now be in compliance with Sarbox, but the push for transparency that it set in motion is rippling out in all directions, and there is scarcely any aspect of corporate accounting — from overarching principles to specific standards — that isn't ripe for reconsideration. "I've been a student of financial reporting for 25 years," says Greg Jonas, managing director of Moody's Investors Service, "and I've never seen a time when so many big-ticket financial-reporting issues were in play."

Those issues cover enormous ground, from the macro (Will generally accepted accounting principles still be accepted?) to the micro (specific changes to lease, pension, securitization, and other accounting standards that could have a major impact on companies' reported results). In between those extremes are issues such as the move to fair-value accounting, which could affect everything from hedging strategies to emissions credits, and a push to overhaul financial statements to make them better reflect corporate performance (see "Work Zone Ahead" at the end of this article).

Enter the "Complexity Committee"

Adding a further wrinkle to these interesting times is the fact that no single organization or entity has complete dominion over all aspects of corporate reporting. Nor do investors, companies, and lawmakers always agree on how to proceed or even what the destination should be. While it is true that the Securities and Exchange Commission has asserted itself more vigorously in the wake of Sarbox (see Part 2 of this series, "The SEC Rules," August), the broad scope and complexity of financial reporting demands some level of collaboration among a wide range of parties.

That was made clear in July, when the SEC established the Advisory Committee on Improvements to Financial Reporting. Known as CIFR or, more colloquially, the "Complexity Committee," it comprises 17 experts from academia, banking, law, Wall Street, and Corporate America. The group has been asked to make recommendations on everything from the relative merits of rules-based versus principles-based accounting systems to "current systems" for delivering financial information to the manner in which accounting and reporting standards are set and whether any current standards could be deemed unnecessarily complex or costly — or unnecessary altogether.

"Financial statements should do a good job for both preparers and users," says Robert Pozen, chairman of MFS Investment Management and also the chairman of CIFR. "There are a lot of people who are trying to get it right, and yet [the high incidence of misstatements indicates that] something isn't working here." In fact, Pozen says, "most individual investors are probably throwing them [financial statements] in the trash, and sophisticated investors want a lot more information in different formats," so no one is happy.

That fact has not been lost on the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB), which have been collaborating on the so-called presentation project since 2005. Whether CIFR's work dovetails or conflicts with the FASB/IASB effort is unclear, but it is reasonable to assume that such wholesale changes to financial statements will increase complexity for users and preparers, at least initially. One early set of revised financials that was distributed during a meeting of the Financial Accounting Standards Advisory Council (FASAC, a cross-section of businesspeople who advise FASB in much the same way that CIFR will advise the SEC) this past spring provided a side-by-side comparison of how financial statements might look at some point. The familiar income statement would be replaced by a statement that, in theory at least, would provide greater detail on the different types of income generated, so that investors could see core earnings versus earnings related to financing or investing activities.

"There's a wholesale commitment to this," says Leonard Griehs, vice president of investor relations for Campbell's Soup Co. and a FASAC member. "But I hope that they [FASB and the IASB] do it in a way that doesn't put companies through a lot of work that doesn't do all that much for investors."

If efforts to revamp financial statements appear duplicative, that's just the start. In the broader effort to rethink various aspects of financial reporting, work is under way at three (and possibly more) FASB committees, a new Treasury Department advisory committee, the Public Company Accounting Oversight Board (PCAOB), and the House Financial Services Committee.

"There are definitely too many cooks in the kitchen," says Marc A. Siegel, director of research for the Center for Financial Research and Analysis and a member of FASB's Investors Technical Advisory Committee, which was formed earlier this year. "There's way too much lobbying going on in Washington in an effort to influence accounting rules. I'm afraid this is turning into a turf war." That can sometimes be exacerbated by a combination of current events and politics, as when the recent crisis in the subprime market prompted the House Financial Services Committee to explore proposed changes to securitization accounting.

The People with the Power

Those with long memories may be tempted to shrug off concerns that this spate of activity will produce chaos en route to profound change. After all, the staid world of accounting has been known to erupt periodically in a burst of reformism. The 1970s had the Cohen Commission; the 1980s the Treadway Commission; while in the early 1990s the Jenkins Committee, created by the American Institute of Certified Public Accountants to provide a new blueprint for financial statements, even managed to give detailed examples. Yet few today can recall those early efforts, or what fruit they may have produced.

But Pozen vows that CIFR will have a lasting impact, one that perhaps defies comparison to mere accounting groups of days gone by. "First of all, this group has the strong support of Chris Cox, Bob Herz, and Mark Olson," he says, referring to the heads of the SEC, FASB, and the PCAOB, respectively, "so we have a good chance of getting something done." Asked to compare CIFR to another recent high-profile group with a different focus, Pozen says simply, "With the 9/11 Commission, the political backing was unclear."

One advantage that CIFR has over other groups, he explains, is that it is composed of "the people who have the power to change the rules. They're helping to find the issues and examine them, so at the end, the report goes to the decision-maker. The analogy would be if the 9/11 Commission had been staffed with members of the National Security Agency."

Despite Pozen's metaphorical comparison to a spy agency in describing the work of a committee devoted to corporate transparency, his point about the alignment of interested parties and the will to make changes is well taken. There is broad interest in creating one set of accounting rules that would work whether a company is based in Dayton, Dusseldorf, or Dar es Salaam. Although FASB and the IASB have been taking baby steps in that direction ever since the 2002 Norwalk agreement, the move seems to be on a much faster track following the SEC's concept release on August 7. In 42 pages, the SEC spelled out 35 questions, including these two shockers: Is there a scenario under which it would be appropriate for the commission to call for all remaining U.S. issuers to move their financial reporting to IFRS? And, would it be appropriate for U.S. issuers that move to IFRS to be allowed to switch back to U.S. GAAP?

That the SEC has even voiced these questions has caused a huge stir. Jack Ciesielski, publisher of the *Analyst's Accounting Observer* newsletter, commented that, "This is an idea that's ahead of its time. Not a bad idea — just ahead of its time."

Others have been less restrained. George Washington University Law School professor Lawrence A. Cunningham quickly fired off a six-page letter to the SEC, arguing that "pursuing the concept would amount to a leap of faith, rich with paradox and irony. One paradox is how moving to a single set of global standards means the U.S. would have a double set of internal standards. One irony is how the Concept Release acknowledges, twice, that the whole notion is complex, while the Commission simultaneously says it is fighting against complexity in financial reporting!"

Is Simplicity Too Complicated?

The counterargument is that long-term simplification will be worth short-term complexity, and that, in fact, a historical resistance to major change is at the root of today's complexity. "We need to create a financial-reporting system that will serve us for the next generation. Otherwise, it's just another patchwork job," says Neri Bukspan, chief accountant at rating agency Standard & Poor's. Still, Bukspan is the first to admit that creating something that appeals to every constituency that uses financial statements is going to be a lot harder than it sounds. "The goal of financial statements for everyone is a utopian ideal, much like creating a universal language that everyone can understand. We all know what happened with Esperanto."

Some standards do prove worth the pain. Bukspan points to the euro, which evolved from an accounting standard to a physical currency to a dominant currency, with plenty of resistance and griping along the way. Might a move toward global standards for reporting follow suit? Bukspan's colleague, Ron Joas, an accounting specialist at S&P, is doubtful. "Over the years, there's been constant talk about the need to simplify," he says. "But once you get down to the things that really need to be considered, and the fundamental question of what financial reporting is supposed to be, it's not easy to meet the needs of every constituency in a single document."

Pozen acknowledges that "we need to deal with the tension that's there and understand it," but is confident that can be achieved. Others worry not so much about outright failure as partial success: What if various constituencies agree that GAAP no longer suffices but can't agree on how to change it? Would that lead to a sort of accounting free-for-all? Griehs of Campbell's says that is a legitimate concern. "There's definitely a need to change — everyone knows that," he says. "But let's make certain that everyone is moving in the right direction."

Certainty, once a quality that many people assumed was the bedrock of accounting, isn't what it used to be. Whether CIFR, FASB, and the SEC can change that — and how quickly — will become clear in the next two years.