

# The Report Card on Financial Reporting

by Greg Zegarowski

Whoever thought they would see the day when talking about what accountants do for a living would find its way into the media and social gatherings? To say that the U.S. financial reporting system is in flux understates the tidal wave of attention that is currently being devoted to the subject. The report card on the quality of financial reporting in the business community shows a mixed picture of achievement.

While it is easy, in light of all the recent business scandals, to criticize the existing financial reporting system, we must remember that it has, by no means, been a complete failure. We have extensive publicly reported information, many well-trained professionals—and an independent press to catch the system when it falls short.

Many of the scandals that we have witnessed recently could be attributed to governance failures and flagrant executive fraud. There is plenty of blame that can and should be absorbed by key executives. Nevertheless, improving our overall financial reporting system is essential. This is so not only for individual investors but also for our economy as a whole. Without confidence in the numbers and the counters, trade and investment, the mother's milk of our economic system, will dry up.

## SARBANES-OXLEY

In response to the financial reporting crisis in corporate America, Congress passed the wide-ranging Sarbanes-Oxley Act of 2002. The Act affects almost everyone associated with public companies, including management, audit committees, independent auditors, lawyers, and security analysts.

The Act, among other things, requires:

- Establishment of a five member Public Company Accounting Oversight Board that will oversee the audits of the financial statements of public companies through registration, standard setting, inspection and disciplinary programs.
- Quarterly and annual certifications by CEOs and CFOs regarding the annual reports and internal controls of their companies
- Corporate disclosures requiring board audit committees to include at least one member who is a financial expert
- Restrictions on public accounting firms from performing certain additional services for audit clients such as financial system designs and implementations.

Penalties for violations of the Act are stiff and can include imprisonment. Congress has sent a message that integrity in financial reporting is a serious matter. It is hoped that the provisions of the Act will strengthen the financial reporting system. The SEC is charged with fleshing out specific rules for some of the provisions of the Act. It remains to be seen how positive the impact of the Act will actually be. By many accounts, the SEC is underfunded and under-staffed.

Further complicating efforts at reform is that, at the time of the writing of this article, we are without leaders in both the Securities and Exchange Commission (SEC) and the newly formed Public Company Accounting Oversight Board (PCAOB). We can only hope that ethical credibility, rather than

political interests, will decide the leadership of these key agencies.

#### WHO CONTROLS FINANCIAL REPORTING?

The financial reporting system up until recently has rested on organizations such as the Financial Accounting Standards Board (FASB), the Accounting Standards Executive Committee (AcSEC) of the American Institute of Certified Public Accountants (AICPA), the Emerging Issues Task Force (EITF), the International Accounting Standards Board (IASB) based in London, and the SEC.

Among these various entities there has been increased discussion about finding convergence. Convergence means finding consistency in the rules promulgated by the various bodies. Despite the plethora of existing rules and policies, though, rules have not been developed fast enough to keep up with the current complexities of business transactions and arrangements. For example, the FASB has accelerated their deliberations on special-purpose entities (remember Enron).

#### MOVING FROM RULES TO PRINCIPLES

Certainly, having more rules makes life a little easier for some people. With increased maturity, however, people (hopefully) develop greater moral sensibility. Parents, for example, cannot turn to specific rules for every decision facing them in raising a child. Parents must rely on their best judgment based on general principles and values.

Since today's financial system is characterized by constantly increasing innovation, principle-based standards can help guide practitioners where specific rules are not yet defined. Robert Herz, chairman of the FASB, addressed this issue in a speech delivered at the Financial Executives International Conference on Current Financial Reporting Issues on November 4, 2002 (entire speech can be

found at [www.fasb.org](http://www.fasb.org)): *"While rules are sometimes unavoidable, the intent is not to try to provide specific guidance or rules for every possible situation. Rather, if in doubt, the reader is directed back to the principles."*

Regarding a recent FASB proposal that is awaiting public comment, Herz said: *"In short, it requires preparers, auditors, audit committees, and boards to be willing to exercise professional judgment and to resist the urge to seek specific answers and rulings on every implementation issue and to view accounting and reporting as an exercise in good communication and not just compliance."*

#### ONLINE TO THE FUTURE – TAKING ADVANTAGE OF TECHNOLOGY

Part of the overall improvement to financial reporting may take a decidedly technological tack. The Nasdaq, Microsoft, and PricewaterhouseCoopers have joined forces to develop a new platform for corporate reporting over the Internet. (For a demonstration of this new technology go to <http://www.nasdaq.com/xbtl/>). The technology will allow easier analysis and comparison of financial information from public companies in three broad categories:

- Financial measures – e.g. total revenue, net income
- Ratios – e.g. return on investment
- Financial statements – e.g. balance sheet and income statement

The new technology can help inform investors about the relative strengths of different companies. However, if there is a lack of integrity in the numbers that go into published information then investors could still have their judgments adversely affected. The responsibility for achieving this integrity resides with the entire financial reporting system, especially financial executives and auditors.

## A NEW VIEW OF THE BOARDROOM

The impact of the recent scandals has found its way to the top of the corporate ladder. Some board candidates are thinking twice before accepting positions. Stephen Fowler is President of Boardseat.com, a retained search firm that focuses exclusively on board director and advisor searches. In a recent conversation with the author, Fowler noted that there are several reasons that contribute to board candidates currently being less inclined to accept board positions. These include

- Sarbanes-Oxley legislation
- Recent high profile scandals
- Concerns about liability (more perceived than real except in the case of fraud)
- Stock market decline that has made stock options less attractive (there is a sense among many that the rewards don't now match the perceived risk)
- A lot of CEOs are fully engaged with their own poorly performing companies and don't have the time to devote to outside boards
- Some investors are putting pressure on CEOs to take fewer outside board seats (for the same reason).

According to Fowler, there is now a general consensus that sitting on a public company board is a serious responsibility requiring a lot of work. Fowler commented, *"It is fair to say that the atmosphere in some board rooms a couple of years ago probably resembled that of a country club rather than that of a board room. With the recent changes, I am sure that is no longer the case."*

## CORPORATE VS. INDIVIDUAL RESPONSIBILITY

### – A BOTH/AND GAME

We need better systems and we need more individual integrity throughout the financial reporting process. We cannot regulate away every opportunity for individual avarice. Neither can we assume that the personal virtue of executives can overcome

or compensate for all of the weaknesses in our financial reporting system.

This essay has concentrated on the current state of affairs from a corporate or systemic perspective. We must, however, applaud and support efforts in business schools as well as in the corporate sector that foster growth in individual integrity and in ethical leadership. It is a both/and, not an either/or, game.

As a business community and as a society we have been rocked by the recent high profile scandals. Accounting professionals, Congress, and businesses have already taken steps to improve our reporting systems.

The upside to the business community is that we may emerge from the recent disasters with better and timelier information to judge and manage companies. However, there are always strong tendencies to return to *"business as usual"*. Therefore, in addition to supporting systemic improvements to our financial reporting system we must maintain our individual resolve to build successful businesses through sound ethics.

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