

the markets
have gone cold
but the crisis is still

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By Ronald Kral, MBA, CPA, CMA



The letters 'o' and 't' are rendered in a thick, yellow, sans-serif font. The 'o' is a simple circle, and the 't' has a vertical stem and a horizontal crossbar. They are positioned on the left side of the page, with the 't' extending higher than the 'o'.

Greed and unethical behavior are certainly behind the sub-prime mortgage crisis and the resulting credit freeze. The reality is that greed and poor ethics will always be present because no legislation can ever be successful in its eradication. While Congress, and indeed the world, is debating solutions to this latest global financial crisis, the key is to identify root causes to pave the way for effective solutions.

HOW INDEPENDENT OVERSIGHT IS CRITICAL FOR LONG-TERM SOLUTION TO FINANCIAL CRISIS

The primary breakdown leading to today's crises is nothing new; it is simply the lack of a truly independent board to question risks and hold management accountable for full and accurate disclosures. Unfortunately, many are pointing to misguided fixes, such as scrapping mark-to-market accounting. Let's explore the condition, cause and potential solutions from the perspective of public companies under the regulatory eye of the Securities and Exchange Commission (SEC).

Market transparency required

The SEC's mission is to protect investors by ensuring a steady flow of timely, comprehensive, and accurate information. To achieve this mission the SEC has issued an abundance of rules and regulations regarding disclosure. One such rule requires companies to provide material historical and prospective disclosure. This rule requires the management of companies to discuss in their SEC filings uncertainties that will result in, or that are "reasonably likely" to cause, the reported historical financial information not to be indicative of future operating results or financial condition. This goes well beyond the historical context of U.S. GAAP by requiring the disclosure of forward-looking information that could reasonably have a material impact on the future.

more surprises to come

Despite these SEC disclosure requirements, the long parade of asset write-downs continues to surprise the investing community. A vicious cycle ensues as credit rating agencies downgrade the debt collateralized with these impaired assets,

leading to a loss of investor confidence and a tightening of the credit markets. Investor fear and herd mentality kick in, leading to a stampede of extreme market volatility.

To make matters worse, a significant portion of financial assets are traded, pooled and repackaged for sale as complex derivatives. Many of these financial instruments were collateralized with real estate. The securitization leading to these complex vehicles was a popular way to achieve growth and hefty returns for several years. With the passage of time came more creativity and risk, while loan quality decreased. The U.S. real estate market simply could not support the valuations given to these increasingly risky securities. Add in credit default swaps (CDS), which are insurance-like contracts that cover potential losses on securities in the event of a default, such as mortgage-backed securities, and you have a toxic soup that no one is sure how to digest.

Former SEC Chairman Christopher Cox noted on Sept. 26, 2008 (SEC Release 2008-230) that the approximately \$60 trillion CDS market "is regulated by no agency of government." This is the same SEC release that quotes Chairman Cox as saying "the last six months have made it abundantly clear that voluntary regulation does not work" in response to the SEC ceasing a voluntary regulatory program for global investment bank conglomerates. Expect more market volatility, pain and regulation.

Managing risk in the boardroom

Boards of directors should be asking; why weren't these risks identified and disclosed? It appears that management did not honestly deal with these risks and disclosures in lieu of the quest to maximize short-term returns. Indeed, the age-old culprits of short-term thinking and the lack of holding top executives accountable are at the forefront of the market turmoil.

Corporate America's persistence to not separate the chairman and CEO positions from being held by the same individual is the single greatest hindrance to strong governance and risk management. It is an indefensible conflict of interest for one person to lead both the board and management team when the primary objective of the board is to hold management accountable. However, the vast majority of the companies making headlines this year, such as Lehman Brothers, AIG, Freddie Mac, Wachovia Bank, Washington Mutual and many others, had one person as both their chairman and CEO, according to 2008 SEC filings.

Mark-to-market accounting

Federal regulation tends to be reactionary and riddled with unintended consequences. Few like regulation, but most agree it is necessary to some degree. While the recently enacted Emergency Economic Stabilization Act (EESA) provides \$700 billion to restore liquidity and stability to the financial system by authorizing the U.S. Treasury Department to purchase troubled assets of financial institutions, it is the controversy of mark-to-market accounting that is especially intriguing.

There is a lot of finger-pointing these days and the assault on fair-value accounting is one of the louder victims. The EESA calls for a study on mark-to-market accounting standards as provided under Financial Accounting Standard No. 157 (FAS 157). The legislation also grants the SEC the authority to suspend the application of FAS 157. Fair-value accounting is also referred to as "mark-to-market" accounting. It simply means that financial assets and liabilities are disclosed at market prices as of the balance sheet date.

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recommendations

The federal government should:

- Resist the pressure to abandon mark-to-market accounting.
- Beef-up monitoring and enforcement of regulatory disclosures.
- Prohibit public companies from having one person serve as both chairman of the board and CEO.

Companies should not wait for regulation, but rather take the initiative to:

- Structure true independence

between the board and management team to help ensure a robust long-term risk assessment process, accurate and transparent disclosures, and management oversight in the best interest of shareholders and debt holders.

- Secure board-level resources to provide a healthy level of independent monitoring of management's activities, especially risk assessment.

The topic of risk should be:

- Prioritize the responsibilities of a disclosure committee consisting of

a diverse group of senior executives as one means to hold management accountable.

- Consider "claw-back" provisions to senior executive compensation packages in the event of poor material disclosure or financial restatements.
- Invest in disclosure controls, including testing their effectiveness. Without these efforts, a company is at risk of losing its most important asset, credibility.

The objective is improved transparency by reflecting the current market value of assets and liabilities in determining a company's financial position rather than the historical transaction price. This seems logical as a company's balance sheet should ideally reflect the true value of assets and liabilities rather than a historical number that may be nowhere close to its market value. Recent clarification from the Financial Accounting Standards Board (FASB) on FAS 157 also provides new flexibility to re-price assets in an inactive market, such as what we are experiencing today with complex financial assets being very difficult to value.

Some members of Congress and many others are calling for a suspension of FAS 157 since it is now leading to asset write-downs during these economic challenging times. However, to roll-back the progress of FAS 157 will not create greater transparency, but in fact lessen transparency. It's interesting that we did not hear these cries during the economic good times. In a recent FASB meeting, Bob Herz, chairman of FASB, said financial reporting is "not there for regulatory capital, or to boost the balance sheets of financial institutions." This is absolutely correct: Financial reporting should call it as it is and not be used as a pawn for distorting disclosures. The concept of adjusting impaired assets downward has long been imbedded in U.S. GAAP and is consistent with accurate and transparent disclosure.

It's not the scoreboard's fault

Blaming the credit crisis on fair value accounting is like blaming the scoreboard when your favorite sports team loses. Rather, the blame and the ultimate solution lie in the governance structure and practices of companies. When boards fail to satisfy their obligations to protect the interests of shareholders and debt holders by failing to assess and respond to risk, they must be held accountable, just as management must be held accountable by the directors.



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