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October/November 2009

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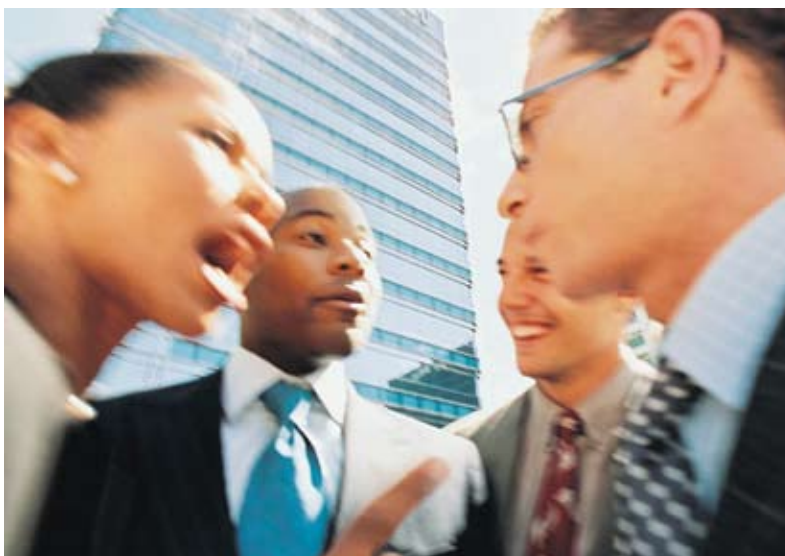
The Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 157, *Fair Value Measurements*, three years ago, and people have been arguing about it ever since. The controversy reached a boiling point last fall, when critics claimed that, by emphasizing market prices over other valuation methods, SFAS 157 contributed to Wall Street's financial meltdown.

Since then, the Board has issued a series of FASB Staff Positions (FSPs) intended to ease the financial community's concerns. It's important for corporate leaders to keep up with these recent developments in fair value accounting and understand how they affect their companies.

Is an "exit price" fair?

SFAS 157 establishes a three-tier fair value hierarchy that emphasizes three market-based valuation inputs:

Level 1. Quoted prices in active markets for *identical* assets or liabilities.



Level 2. Observable inputs, including quoted prices for *similar* assets or liabilities in active markets, quoted prices for identical or similar assets or liabilities in *inactive* markets, and other market data.

For many commentators FSP FAS 157-f raises questions about whether fair value is an appropriate measure for liabilities.

Level 3. Unobservable inputs, such as a company's own cash-flow projections or other internal data.

The statement gives the highest valuation priority to Level 1 inputs and the lowest to Level 3 inputs. But regardless of the type of inputs used, fair value measurement's objective is to determine an "exit price" from the perspective of a market participant that holds the asset or owes the liability. Critics, however, have expressed concern that SFAS 157's focus on the exit price would require a company to value assets and liabilities at "fire-sale" prices.

Last fall, FASB responded with FSP FAS 157-3, which provided guidance on determining fair value when the market for an asset or liability isn't active. FSP FAS 157-3 clarified that a market's inactive, observable inputs may require "significant adjustment" based on unobservable data and that determining whether transactions are forced liquidations or distressed sales may call for "significant judgment."

Distress testing

In April, FASB issued FSP FAS 157-4, *Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly*. This FSP introduces a two-step process:

- 1. Determine whether the asset's or liability's market is inactive.** The FSP provides a list of factors that indicate an inactive market, such as a lack of recent transactions, price quotations that aren't based on current information or price quotations that vary substantially over time.
- 2. If the market is inactive, determine whether quoted prices reflect fair value.** The FSP calls for individual transactions to be evaluated. Several signs may indicate that a transaction was distressed, such as inadequate market exposure, marketing of the asset or liability to a single bidder, or a seller in or on the verge of bankruptcy or receivership. If the quoted prices reflect forced liquidations or distressed sales, they'll require significant adjustment in calculating fair value.

In the absence of sufficient information to determine whether a transaction is orderly, companies should consider the transaction price in its calculations but the price shouldn't solely or primarily determine fair value.

FSP FAS 157-4 is effective for interim and annual reporting periods ending after June 15, 2009, and will be applied prospectively. Earlier adoption is permitted for periods ending after March 15, 2009. By allowing companies to place less emphasis on valuation inputs that reflect transactions that aren't orderly, FSP FAS 157-4 will have a positive impact on many companies' financial statements.

Valuing liabilities

Proposed FSP FAS 157-f, *Measuring Liabilities under FASB Statement No. 157*, lends some clarity to the particularly difficult issues related to determining the fair value of a liability. For example, SFAS 157 defines fair value as the price that would be paid in

FSP FAS 157-f rekindles controversy

Besides providing guidance on a critical issue, proposed FASB Staff Position (FSP) FAS 157-f has rekindled interest in a fair value controversy that hasn't received much attention in the last few years. Because SFAS 157 requires that a liability's fair value reflect non-performance risk (including the reporting entity's credit risk), marking a liability to market can create an anomalous situation: When the fair value of a company's liabilities declines, it books the difference as a *gain*.

Under certain circumstances, that might be the proper outcome. But what if a company's bond prices drop as a result of a decline in its own credit rating? Critics feel that allowing a credit-rating downgrade to boost a company's income doesn't make sense. Unfortunately, there's no easy way to address this problem within the SFAS 157 framework.

an orderly transaction between market participants. But liabilities — which typically contain contractual transfer restrictions — are rarely bought and sold in the marketplace.

According to FSP FAS 157-f, if a quoted price exists for the identical liability in an active market, that price is a Level 1 input. If such an input isn't available — which will likely be the case in most situations — a company should measure fair value based on the following (maximizing the use of observable inputs):

- ▶ The quoted price of the identical liability traded as an asset (a bond, for example) in an active market,
- ▶ The quoted price of the identical liability (or the identical liability traded as an asset) in an inactive market,
- ▶ The quoted price of *similar* liabilities (or similar liabilities traded as assets) in active markets, or
- ▶ Another valuation technique that's consistent with SFAS 157, such as a present value computation or a market approach based on what the company would receive for an identical liability at the measurement date.

Under the proposed FSP, companies would adjust the price of a liability traded as an asset to reflect factors specific to the asset. But there would be no separate input or adjustment relating to contractual transfer restrictions. In FASB's view, such restrictions are implicitly or explicitly included in other inputs.

Proposed FSP FAS 157-f provides useful guidance on measuring the fair value of liabilities. But for many commentators it also raises questions about whether fair value is an appropriate measure for liabilities. (See "FSP FAS 157-f rekindles controversy" on page 3.)

The debate continues

The most recent FSPs provide welcome, practical guidance on how to apply SFAS 157 and, in many cases, will have a positive impact on public companies' financial statements. At the same time, analysis required by the new guidelines will make the valuation process more complex.

FASB will likely provide additional guidance in the future as companies continue to face the challenges involved in implementing fair value accounting. ■

Controls monitoring: Turn a burden into an opportunity

For several years now, Section 404 of the Sarbanes-Oxley Act of 2002 (SOX) has required public company management and external auditors to report on the adequacy of a company's controls over its financial reporting. To comply, most companies have adopted the internal control



framework published in 1992 by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

A key component of the COSO framework is monitoring, but many companies underuse it. To educate corporate leaders on the benefits of monitoring, COSO published its *Guidance on Monitoring Internal Control Systems* earlier this year. The three-volume set can help your company address and improve ineffective or inefficient monitoring.

COSO's framework

COSO's internal control framework is built around five interrelated components:

1. **Control environment**, which includes setting the "tone at the top" and developing an ethical business culture,
2. **Risk assessment**, which helps a company establish objectives and manage risks related to their achievement,

3. **Control activities**, such as approvals, authorizations, reviews, segregation of duties and other policies and procedures,
4. **Information and communication**, which includes effective upstream and downstream communication within a company as well as communication with external parties such as customers, suppliers, regulators and shareholders, and
5. **Monitoring**, which assesses the quality of the internal control system's performance over time.

Too often, companies view this last component, monitoring, as an extraneous burden and don't fully understand how it can support their assessments of internal controls.

Benefits of monitoring

In the introduction to its new guidance, COSO explains that monitoring can "streamline the assessment process," help companies maintain the quality of internal control systems and enable them to achieve significant efficiencies. Effective monitoring, for example, can reduce the need for certain control testing and allow for shorter, more cost-effective audits.

COSO's monitoring guidance relies on two fundamental principles that are rooted in how monitoring benefits a company. First, whether it's based on ongoing or separate evaluations, monitoring helps management assess whether other internal control components continue to function over time. Second, it ensures internal control deficiencies are identified and communicated in a timely manner.

Action is critical

For your company to follow these principles, you need to establish a foundation for monitoring. Start by setting the proper tone at the top. Then build an effective organizational structure that assigns monitoring roles to qualified, objective people and identify a "baseline" of known effective internal control.

Next, design and implement monitoring procedures that enable you to focus your resources on

the areas that are most relevant to your evaluation of internal control and eliminate costly monitoring procedures that have a lesser impact. This step is particularly critical for smaller public companies, which typically have fewer resources to devote to monitoring. Finally, establish a system for evaluating and reporting identified deficiencies.

Weighing the scales

According to COSO, there's a wide variety of monitoring procedures to choose from, including:

- ▶ Periodic evaluation and testing of controls by internal audit,
- ▶ Continuous monitoring programs built into information systems,
- ▶ Regular analysis of key performance indicators or other metrics that might signal control failures,
- ▶ Supervisory reviews of controls, such as reconciliation reviews,
- ▶ Self-assessment by boards and management,
- ▶ Audit committee inquiries of internal and external auditors, and
- ▶ Quality assurance reviews of the internal audit department.

In designing a monitoring program, you need to consider how you'll balance *indirect* information, such as key performance indicators, and *direct* information, such as testing of controls. Too much reliance on indirect information can allow small errors to go unnoticed and eventually grow into material errors. And, ironically, indirect information can sometimes appear to be normal as a result of the very control deficiencies it's designed to detect.

Control the process

Assessing and reporting the adequacy of internal controls remains a significant, costly and time-consuming task. But COSO's monitoring guidance can at least help you streamline — and better control — the process. ■

Deferred compensation

Put your plan in place now

Deferred compensation remains a powerful tool for attracting and retaining management talent. But current legal requirements make these arrangements less flexible than they once were and require you to establish a plan *before* the year in which deferred compensation will be earned.

An initial election to defer compensation must be made before the year in which the compensation will be earned.

What the law requires

Internal Revenue Code Section 409A is designed to bar deferred compensation arrangements that give executives too much control over the form and timing of their own benefits. Sec. 409A covers most *nonqualified* deferred compensation, including:

- ▶ Supplemental executive retirement plans (SERPs),
- ▶ Plans that allow executives to elect to defer a portion of their annual salary,
- ▶ Bonus deferral plans, and
- ▶ Certain severance pay or split-dollar insurance arrangements.

The restrictions also apply to *discounted* stock options and stock appreciation rights (SARs) — but not to options or SARs that are issued at fair market value.

Sec. 409A does not apply to:

- ▶ 401(k) and other qualified plans,
- ▶ Most welfare benefit plans, such as vacation leave, compensatory time, sick leave or disability pay, or
- ▶ Certain short-term deferrals, such as a bonus that's paid within the first 2½ months of the following tax year.

What's more, compensation that involves a transfer of *property* — for example, restricted stock — isn't covered because it doesn't involve a deferral of income.

Regulations snapshot

The 409A regulations are complex, but they can be summarized by a couple of simple and



important rules. First, an initial election to defer compensation must be made before the year in which the compensation will be earned.

If, for example, employees want to defer 2010 compensation to 2011 or later, they generally must make the election by the end of 2009. (Special rules apply to new employees and certain performance-based awards.)

Second, deferred compensation must be payable on a specified date or dates. Payments can adhere to a fixed schedule, or be payable when a certain event occurs, such as death, disability or termination of employment. Also, employees can delay (but not accelerate) receipt of deferred compensation. The election must be made at least 12 months in advance of when payment was to

occur, and payments must be delayed by at least five years.

These restrictions need to be spelled out in plan documents and then must also be followed to the letter. If you fail to comply, participating employees will be subject to immediate taxation of all vested deferred compensation (even though it won't be paid until a future date), plus interest and a 20% penalty.

Review your plans

If deferred compensation will be part of your strategy in 2010, it's important to review your compensation arrangements as soon as possible. And if it's necessary to change them to comply with Sec. 409A, be sure to do it by the end of this calendar year. ■

Why you should care about free cash flow

Profitability is important, but a company's ability to generate cash may be a better indicator of long-term financial health than earnings, particularly during an economic slowdown. Even if a company is profitable on paper, it won't remain successful for long without strong cash flow — especially *free* cash flow.

Operating vs. free cash

Operating cash flow is generally defined as cash flow from operations after interest and taxes, and operating cash margin is calculated by dividing operating cash flow by revenue.

Unlike operating cash flow, free cash flow has no strings attached. It's available for discretionary activities, such as paying dividends, retiring debt, buying back stock, making acquisitions or simply adding to the coffers — without impeding a company's ability to continue generating cash.

To enhance shareholder value, profits alone aren't enough; ultimately, a company must generate free cash flow to satisfy investors. So free cash margin (free cash flow divided by revenue) may be a better measure of economic strength than operating cash margin.

Some good news

The Georgia Tech Financial Analysis Lab tracks and reports a "free cash margin index" for nonfinancial companies. In its First Quarter 2009 report, the authors explain why maintaining positive free cash flow is important: "Companies that consume cash must continually seek new sources of capital ... and those sources ... will dry up or become prohibitively expensive" unless the company shows some progress toward positive cash generation.

The report also reported that the median free cash flow margin for the 12-month period ending in March 2009 was 4.6%, up from its recession low of 4.12% in December 2008. This also marked the margin's first improvement since December 2007. Notably, free cash flow margin improved even as corporate profitability declined. The authors attribute this to "a small reduction in capital spending and a more sizeable decrease in the cash cycle" as companies become leaner and meaner.

