Executive Risks

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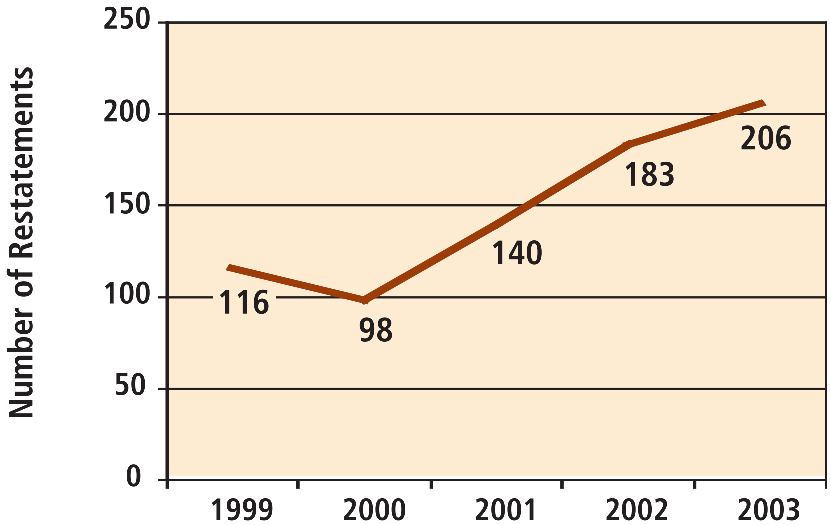
Financial Accounting Standards: Looking Forward

There is a sea change coming. Financial statements and restatements have been at the heart of many of the claims made against US companies and their executives. This has caused a number of those who establish the standards for financial statements to question the underlying basis of our financial rules. The consensus has been that in attempting to set detailed rules with allegedly rigid, bright-line tests we have perhaps lost sight of the goals of financial reporting. Perhaps it is time for us to move to a more principles-based accounting system rather than rules-based; that a *do-the-right-thing* approach might be better than a *let-me-tell-you-what-to-do* methodology.

Restatements of Annual Financial Statements

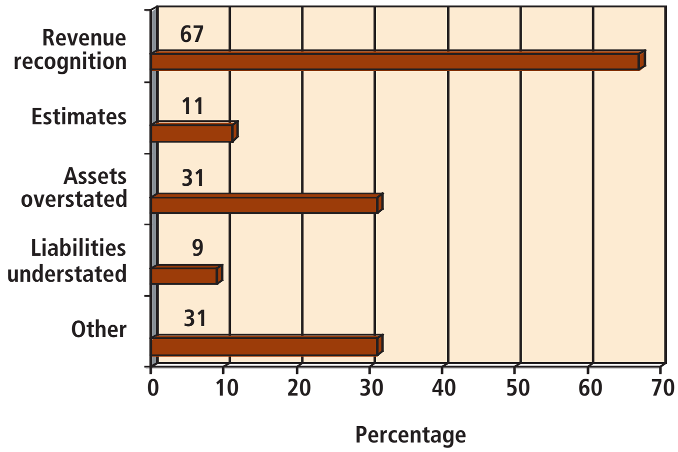


Source: ***Huron Consulting Group, Summary: 2003 Annual Review of Financial Reporting Matters***

The Financial Accounting Standards Board (FASB) sets the rules for financial reporting by US corporations. These are referred to as "generally accepted accounting principles," or GAAP. In turn, the Financial Accounting Standards Advisory Council, (FASAC) advises the FASB on issues related to projects on the FASB's agenda, possible new agenda items and setting project priorities. Recently, FASAC released its report on the suggested priorities for the FASB in 2004 and beyond. For the third year in a row, revenue recognition topped the list of issues that the committee members believed should be the FASB's key priority. This would seem to track with a review of accounting issues that were the subject of the Securities and Exchange Commission (SEC) actions as set out in its litigation releases in 2003.

Contents

Analysis of Accounting Issues in 2003 from SEC Litigation Releases



Source: ***2003 PricewaterhouseCoopers Securities Litigation Study***

A goal of FASB and FASAC is to develop standards that help users assess the financial performance of a business. Two issues were of particular interest to the group. The first was globalization trends - creating financial reporting issues ranging from increased risks to the shift toward a more service-based economy and the resulting accounting issues that this raises. Second was the need for continued cooperation with the International Accounting Standards Board as convergence between varying country-based accounting systems becomes more than an aspiration. This may be of special concern at the current time with roughly 7,000 European companies transitioning to pan-European financial standards in 2005.

Of note to small- to medium-size companies is that the group declined to recommend different financial standards for companies of different sizes (no big GAAP/little GAAP).

Based on this report, the next category that generated significant concern at FASAC appears to be accounting for employee benefit plans with several specific issues being identified. One was a lack of consistency in the selection of assumptions. Another related to the almost uniform confusion among investors when a company recognizes pension “income” in the same period in which its pension assets have declined and its pension obligations have increased. The recent improved disclosure due to the application of FASB Statement 132R has not helped at all in this regard, although it has provided additional new data points with which to compare one company’s pension obligations, assets and assumptions against another’s.

Who Cares What Assumptions Are Used for Pension Funds?

The seemingly obvious answer to the question of who cares about pension and other benefit assumptions would be the plan participants themselves, and possibly the plan enforcement agencies along with the Pension Benefit Guarantee Corporation, which is the backstop insurer of traditional pension plans. However, at this time, the keenest interest appears to be coming from the securities regulators and the investment community, as seen above. Recently, the SEC indicated that it had identified a few dozen companies ''whose assumptions seem aggressive.'' The SEC then began investigating how several companies established the assumptions used in their post-retirement benefits. Adjusting assumptions, if the goal is to inflate earnings and balance-sheet results, would be fraud. At this time, the SEC says it has no evidence of any wrongdoing.

Please note: at least one company has disclosed in a securities filing that it has received a demand from the SEC "to voluntarily produce certain documents and information related to our accounting practices with respect to defined benefit pension plans and other post-retirement benefits."

Of possible interest to the SEC is the discount rate that companies use to calculate future pension liabilities. Companies generally use a rate based on high-grade corporate bonds. In a large pension plan, as little as a half-percentage-point change could result in a $1 billion swing.

A recent study by the National Bureau of Economic Research suggested that before large acquisitions were made, or CEOs exercised their options, pension assumptions appeared to rise, inflating earnings at some companies.

It is likely that we have not heard the last of this line of inquiry.

(New) Proxy Voting Disclosure: Mutual Funds and Pension Funds

Corporate governance – as seen through the lens of proxy voting issues – is in the spotlight. Transparency, accountability and the avoidance of conflicts were the goals of a new SEC rule adopted in January 2004 that requires mutual funds and other registered management investment companies to disclose their proxy voting policies and procedures (as well as the actual proxy votes they cast in filings made on or after July 1, 2003). The new rule should enable shareholders to monitor their funds' involvement in the corporate governance concerns at the companies in their portfolios and may serve to encourage funds

Five Most Important Issues for FASB

1. Revenue Recognition
2. Financial Performance Reporting by Business Enterprises
3. Fair Value Measurement
4. Codification & Simplification
5. International Convergence/ Short Convergence

to vote their proxies in the best interest of fund shareholders. Although these new rules just took affect this past summer, there are already two interesting studies analyzing the possible outcomes and suggesting future actions.

The General Accounting Office (GAO) was asked to consider the issue from the standpoint of pension plans and pension plan fiduciaries. Pension plan fiduciaries have the responsibility for voting the proxies of the shares held in their pension funds on behalf of the plan participants. Sometimes the right to vote the shares is delegated to a third party. In the case of mutual funds held in pension funds, this right is generally assumed by the mutual fund – but the responsibility to monitor the voting process still rests with the plan fiduciaries. Until the new rules for mutual funds and registered investment companies were enacted, pension plan fiduciaries had little ability to peer into the process and verify that the interests of the plan participants were being best represented. Nor did the plan participants themselves have any real ability in the US to determine if their plan fiduciaries where acting as prudent custodians of their proxy votes.

According to the latest reported data, US pension plans directly hold 20 percent of total corporate equities issued by US companies, while mutual funds own another 22 percent (see: March 2004 data from the Federal Reserve Board and the *2004 Mutual Fund Fact Book*). Of course, with pension funds holding mutual funds, they have a very large stake in the issue of who votes or is given the right to vote their proxies.

The second study analyzed some of the recently disclosed proxy votes by the 10 largest mutual fund families, focusing specifically on the issue of executive compensation (see: *Behind the Curtain* from the AFL-CIO Office of Investment). A key finding of this report was that the new SEC rule appears to be having a significant positive impact on the proxy voting practices at some fund families. However, an alleged shortcoming of the new rules is that they do not require the funds to disclose whether they might have a potential conflict in voting a company's stock due to a business relationship between the fund and the company in its portfolio.

It was a similar concern about the potential for conflicts for pension fiduciaries which lead the GAO to conclude in its study that additional transparency (similar to the new rules for mutual funds) and enhanced enforcement is needed on the pension fund side.

Whether these or other changes are made, we are clearly in a new era of accountability and those voting proxies, or responsible for how they are voted, will not be left behind.

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