

Finance Regulatory Compliance

How to Craft a Roadmap

to achieve Compliance

in Turbulent Times

by

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June 2009

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As a consequence of the financial crisis, regulatory reform has become a top priority of domestic and international authorities responsible for standards setting and oversight.¹

In this report, we address practices of the Financial Accounting Standards Board (the FASB) and what organizations need to consider when formulating a response strategy in turbulent times.

The FASB is the rule-making body sanctioned by the SEC to govern the universe of U.S. GAAP accounting and financial reporting. (www.fasb.org)

The calendar of the FASB as of the end of January 2009 is indicative of the regulatory upheaval that is underway. The FASB calendar shows twenty scheduled projects for the remainder of 2009 – fourteen of which are labeled, “credit crisis” projects.

Standards-setting practices of the FASB present three challenges that must be addressed when crafting a regulatory response strategy:

1. The move toward principles-based regulations.
2. Complexity due to interdependencies and overlap.
3. Frequent change: clarification, revision, nullification and replacement of regulatory standards.

Principles-based Rules vs. Detailed Rules

Since issuance of a SEC directive in 2003, the FASB has been gradually moving toward a more principles-based approach to setting standards.^{2,3} Principles-based regulation means placing greater reliance on high-level principles and less reliance on detailed rules such as quantitative limits and ratios.⁸ Principles-based regulations mandate high-level outcomes that require interpretation and exhaustive elaboration by reporting organizations. Accordingly, more time and resources are required to implement principles-based statements than are required to implement detailed, unambiguous rules.

As an example of the principles-based approach, consider a small portion of FAS 163 – the FASB’s most recent formal statement. This standard addresses earnings recognition in a sector of the insurance industry.⁴ In this statement, the FASB sets forth principles-based conditions that govern how the reporting entity is permitted to select underlying insured cash flows to use to calculate earnings.

The FASB states that the decision to use “expected cash flows” – that is, cash flows inclusive of prepayment assumptions – requires that the firm establish internal policy and oversight to apply a three-pronged test by asset class:

- a. Expected cash flows must emanate from homogenous pools of assets;
- b. The option to prepay is, in fact, contractually permissible;
- c. The prepayments can be reasonably estimated on a consistent basis.

If the test cannot be met, then the firm must use contractual cash flows instead of expected cash flows for earnings recognition.

In addition, if actual cash flows at the transaction level significantly deviate from original prepayment assumptions, then the reporting entity must revise prepayment assumptions and make an appropriate adjustment to earnings.

Meeting the Challenge

To respond, the compliance team must interpret and elaborate the requirement to a level of detail that facilitates operational implementation. Such effort, in this case, involves the assessment of cash flow data management practices, creation of oversight procedures, SOX-compliant controls and the enhancement of IT application systems.

2. Interdependent and Overlapping Regulations are the Norm

Consider the list of FASB cross-references labeled, “*Affected by..*” and “*Affects...*” that preface most of the FASB statements and Staff Position papers. Such lists are a maze of backward references that the compliance team must decipher to formulate a comprehensive response to achieve compliance. Also, overlapping jurisdictions add another layer of complexity to the task.⁵

Administrative relief is expected when FASB implements its ‘Codification’ project in July 2009. The Codification project will reorganize U.S. GAAP pronouncements into approximately 90 accounting topics using a consistent structure that will be easier to navigate and search. However, the challenge of interpretation and implementation remains the same.

3. Continuous Change

Regulatory statements undergo frequent change: clarification, amendment, partial nullification and, potential suspension or replacement.

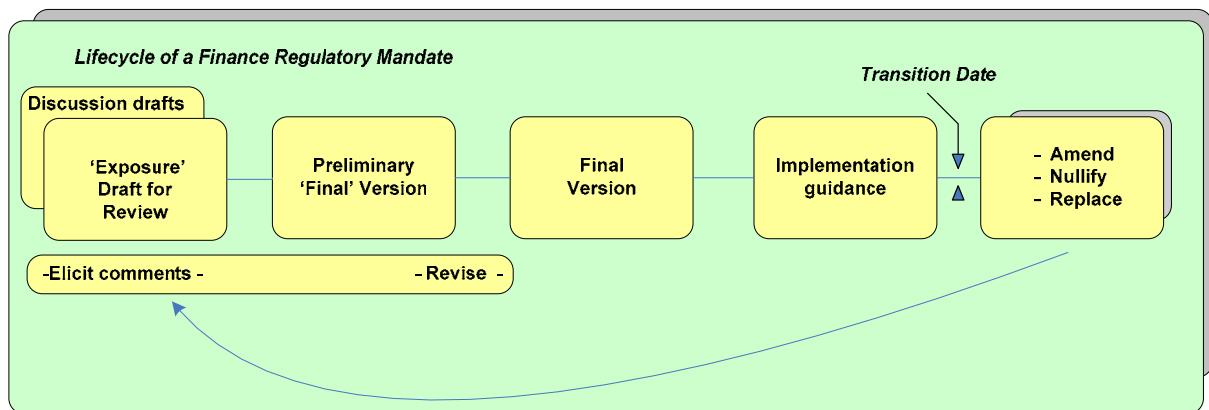
Per the FASB calendar, in addition to the twenty projects scheduled for the remainder of 2009 as previously mentioned, there are:

- Seven statements scheduled for release in 2010 and 2011.
- Nine other topics in the pipeline with a projected statement issuance date of, “To Be Determined”.

Also, the convergence of U.S. GAAP and international accounting standards introduces additional change that must be monitored by the compliance team.⁶

On-going activity indicates that the regulatory landscape is in a continuous state of flux, with each component standard in a distinctive stage of a lifecycle, as illustrated in figure #1:

Figure #1



Similar regulatory lifecycles exist at other authorities. The SEC lifecycle that governs security industry rulemaking follows a familiar path.

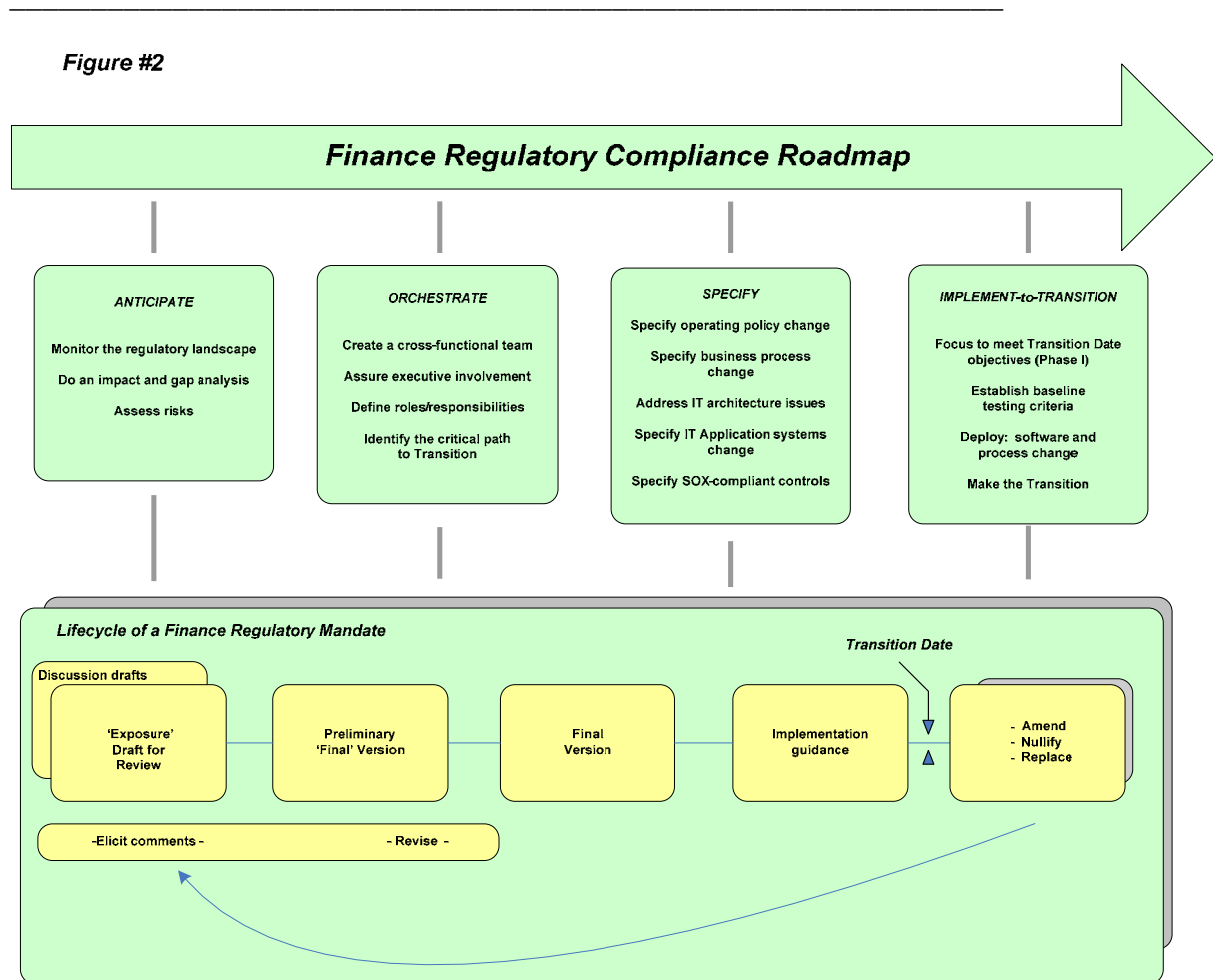
<http://www.sec.gov/rules.shtml>

Also, the Financial Services Authority of the U.K. has a similar lifecycle that governs its rulemaking activity.

<http://www.fsa.gov.uk/Pages/About/What/Approach/Framework/index.shtml>

Implementation Roadmap

Regulatory change is a constant that must be factored into your risk management and regulatory response strategy. We recommend a roadmap, as follows, that is continuously kept in sync with multiple regulatory lifecycles. (figure #2).



***** Roadmap *****

1. Anticipate

- a. Continuously monitor the regulatory environment to identify change that may affect your organization. Monitor regulatory agencies, related standards-setting entities (such as the FASB), accounting firms, industry consultants, competitors, trade associations and partners.
- b. When significant regulatory change becomes apparent, conduct an impact analysis that includes:
 - An inventory of assets that are affected: operating units, operating policy, IT applications, accounting treatment methods, analytics, financial statements and internal controls.
 - A gap analysis: Define the gap between the current-state situation and the targeted future-state environment required to achieve compliance.
 - A risk assessment to set priorities and formulate a mitigation strategy.

2. Orchestrate

Assemble a cross-functional team and develop an agreed-upon project charter that includes:

- A statement of project scope
- Key milestones
- Resource requirements
- Roles/responsibilities
- A timeline with cost estimates
- A process to engage and inform senior management

3. Specify

- a. Create specifications and test cases.
- b. Embrace methods used to manage complexity that are prevalent in the world of IT and business process improvement. The cost of using such methods and tools is now much lower than was the case just a few years ago.

Proven methods include:

- Cross-functional facilitated work sessions
- Use case modeling
- IT-enterprise architecture alignment frameworks
- Object-based domain and event modeling
- Visual work flow scenario analysis
- Throw-away software prototyping
- Web-enabled collaboration and knowledge management

4. *Implement to Transition*

- a. Remain focused on those tasks that enable you to meet transition date objectives.
- b. Conduct a baseline test of financially significant transactional events.
- c. Treat the transition effort as 'Phase I' of an extended timeline. Plan for, and expect that you will need, a 'Phase II' to address remaining tasks and potential new requirements that arise from having made the transition.

Rolling Waves of Reform

Regulatory change will most likely not subside after FASB clears its 2009 calendar.

In January 2009, the Government Accountability Office reported that sweeping regulatory change is likely as a consequence of the financial crisis:

“.. While much of the attention has been focused on taking short-term steps to address the immediate nature of the crisis, these events have served to strikingly demonstrate that the current U.S. financial regulatory system is in need of significant reform. The regulatory system increasingly appears to be ill-suited to meet the nation’s needs in the 21st century.”⁷

Compliance teams are advised to craft an adaptive roadmap that enables them to maintain control during the difficult economic transformation that is now underway.

References

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- ² *Staff Report: On the Adoption of a Principles-based Accounting System*, July, 2003, at www.sec.gov
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- ⁵ *A Snarl of Regulation* by Hanna Fairfield, *The New York Times*, October 5, 2008.
- ⁶ *IASB/FASB Joint Memorandum of Understanding*, the FASB, September 11, 2008 at www.fasb.org
- ⁷ *A Framework for Crafting and Assessing Proposals to Modernize the Outdated U.S. Financial Regulatory System*, U.S. Government Accountability Office, January 2009.
- ⁸ *Principles-based Regulation: Focusing on the Outcomes that Matter*, The Financial Services Authority, April 2007, at: <http://www.fsa.gov.uk/pubs/other/principles.pdf>

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Steve has provided leadership and consultative support to numerous creative IT application development and process improvement teams in the financial services sector, including Citicorp/Citibank, Capital Markets Assurance Corporation (CapMAC), Enhance Financial Services Group, XL Capital and MBIA Inc.

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