A MOMENTOUS FIRST DECADE OF THE 21st CENTURY—FINANCIAL EXECUTIVES LOOK AHEAD AT THE MIDPOINT

For those who keep track of such things, we are just past the midway point in the eventful first decade of the 21st century. And quite a tumultuous decade this "1/21" has been for corporate financial managers! We can begin a look back to the end years of the 20th century with a recalling of "C" suite angst as the dreaded Y2K deadline neared. Key concern: Were corporate and government computer systems going to shut down or misbehave as "19—"became"20—?"Enormous sums of money were invested in fixing, strengthening, and replacing legacy enterprise networks—to the extent that some hardware and software sellers complained that future-year budgets were being cannibalized for Y2K-justified IT projects. It was somehow appropriate that the 21st century would begin with this huge (and expensive) challenge for financial executives. More challenges and changes were to follow, including: the spring 2000 stock market collapse; the onset of a national recession that ended the longest economic boom in our modern history; adoption of sweeping Regulation Fair Disclosure (Reg FD) rules; terror attacks on New York City and Washington, DC in 2001; passage of the comprehensive Sarbanes-Oxley (SOX) package of governance reforms; adoption of tougher NYSE- and NASDAQ-listed company rules; New York Attorney General Eliot Spitzer's attacks on investment bankers, mutual fund advisors, and insurance company executives; structural changes for financial analysts; and more, much more.

All of these developments—stand-alone and intertwined—complicated the lives of corporate managers,boards of directors, and their counterparts in the securities industry.

In these pages we have characterized the years since 2000 as the "Era of Corporate Reformation." Certainly, since the passage of SOX statutes in July 2002, the corporate environment has experienced dramatic changes in accounting processes; financial reporting; accountability to shareholders; the boardroom environment; "C" suite policies and practices; financial research and analysis (as related to specific companies); auditing processes; and financial reporting.

What might the remaining years of decade one of the 21st century have in store for finance executives? Predicting the future is a seriously hazardous occupation with many opportunities for missteps. (We are reminded of the chairman of IBM predicting in 1943 that,"/ *think there is a world market for about five computers.* ")But looking at trends underway—and "things" that can be closely watched in the present—we present here a short list of issues worth watching for their potential impact on business in the years 2006-2010.

Pension schemes—employee pension funds

As we and other pundits have been cautioning for a while now, beware the "pig-in-the-python effect" on your financials (and your business). Picture a python swallowing a large pig, mused author Landon Jones two decades ago in his book, *Great Expectations.* (The pig was the metaphoric Baby Boomers moving through American society, represented by the python.) The Baby Boomers have swept through the past five decades changing much in their path,

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THE DOUBLING OF THE DEMOGRAPHIC COHORTS ABOVE AGES 60, 70, AND EVEN 80 IS ALREADY EXERTING ENORMOUS PRESSURE ON THE VARIOUS PROGRAMS FOR RETIREES IN THE UNITED STATES.

beginning with the crowded hospital corridors where their mothers gave birth.

On January 1, 2006, a momentous event will have occurred: the first of the 76-million strong American Baby Boomer generation will have turned 60. (And for the next 18 years, 4 million men and women will cross that age barrier each year. The Boomers are the post-World War II generation born in the years 1946 throughl964.) The doubling of the demographic cohorts above ages 60, 70, and even 80 is already exerting enormous pressure on the various programs for retirees in the United States, with corporate defined benefit pension plans, union pension plans, state and municipal retirement programs, 401 (k) self-directed retirement plans with employee contributions, the Social Security system, and government-funded Medicare and Medicaid programs among the most prominent. Yes, this is perhaps the best-educated and most affluent generation in our nation's history. But don't expect many Boomers to give up their retirement benefits!

Corporations providing their employees and retirees with traditional defined benefit pension programs—long a mainstay of "social contracts" with the rank and file, especially in the manufacturing and unionized sectors—are now under pressure to decide whether to continue the programs and the prospect of adopting and adjusting to new accounting rules for the plans that will evolve over the next several years. Legions of retiring and soon-to-retire workers will be showing up at the payout window as market returns remain lackluster for pension fund managers.

FASB project: Pension accounting and postretirement benefit plans

In early November 2005, the Financial Accounting Standards Boards (FASB) adopted a year-long initiative that will address the rules for reporting pension fund assumptions (for returns on investment). Pension and postretirement employee benefit (OPEB) plans are now under the FASB microscope. (Remember that SOX designated two main gatekeepers for accounting rules: the FASB and the SEC.)

At the end of this year's initiative, FASB will tackle the thorny issue of how corporations should report the effects of pension plan finances on their balance sheets. The impact of the year 2007 decisions over the rest of the decade could be huge—hundreds of billions of dollars in aggregate changes on public companies' balance sheets will occur, the FASB project manager told the *New York Times.* Corporate earnings could be dramatically reduced by the changes in the rules.

Commenting on the FASB decision to address pension accounting in a comprehensive way, David Zion, CFA, CPA, and Bill Carache, CPA, who head the Credit Suisse First Boston (CSFB) accounting and tax team (and who have been closely following developments in pension accounting treatment), said that "adding a project to the agenda is one thing, crafting a new accounting standard is something else altogether. The project will be very contentious and will take some time." They explain that the FASB decision now moves forward in two phases: First, companies would be required (if rule changes are adopted) to pull the funded status of the pension and OPEB plans out of footnotes and into the balance sheet, maybe by year-end (2006).

Second, the FASB would embrace a multiyear project to reconsider all aspects of pension fund and OPEB accounting, potentially overhauling the current model and perhaps replacing it with a mark-to-market approach. (The pair describe this approach in detail in their 2005 paper, "The Magic of Pension Accounting," available from the authors upon request: see References, below.)

Messrs. Zion and Carache see potentially large impacts for corporations. Defined benefit plans could go the way of dodo birds—eventual extinction—or perhaps be "frozen" in place for only current employees' benefit. "Mark-to-market" approaches could minimize volatility in earnings and on the balance sheet (occurring as plans try to match assets to obligations). Investment decision making for the plan assets could impact the capital markets—where corporate pension plans are major players. An appetite could develop for bonds and fixed-income instruments vs. equities, to reduce volatility (and promote uncomplicated reporting). Duration-focus could change, affecting securities industry market offerings.

Much is at stake in the pension debate over the remaining years of this momentous first decade.

Easing corporate financial pain with employees' giveback

General Motors and the powerful United Automobile Workers (UAW) union recently came to agreement on a new healthcare plan that will require employees to pay a bit more for their portion of healthcare services and give up a $1.00 per hour raise in 2006. These measures will result in at least $15 billion in cost savings for GM. It is expected that Ford Motor Company and the Chrysler division of Daimler-Chrysler (and the UAW) will soon follow the GM model. General Motors lost $4 billion in the first nine months of 2005, with escalating healthcare costs a significant factor.

GM was reported to be considering divesting a portion of its profitable "General Motors Acceptance Corp." (GMAC) finance arm, which would considerably boost GM corporate finances. There's a huge "but" involved: *but,* the Pension Benefit Guaranty Corporation (PBGC) just might put its hand out to receive some of the proceeds of the sale to offset some of the "deficit" that GM's $90-100 billion (estimated) pension plan has incurred. Should GM default on or terminate its plan, a tidal wave of claims would then flow to the PBGC. It should be noted that GM claims that its plan is fully funded and in full compliance with federal regulations; and that the PBGC has expressed concerns about the stability of the GM plan and future liabilities that it could potentially be responsible for.

Financial and business troubles in the metals and airlines sectors have put significant pressure on the PBGC, which is the federal government's agency for insuring defined benefit plans and the payor-of-last-resort for beneficiaries of failed corporate defined benefit retirement plans. The PBGC is also a major creditor in bankruptcy proceedings as companies seek protection from creditors. (The PBGC collects less than 10 cents on the dollar in these proceedings.) The agency is empowered to negotiate "settlements" with companies that have debt ratings below investment grade and under-funded pension plans (in the PBGC's view). (A decade ago, the PBGC reached agreement with General Motors to obtain proceeds from asset sales, such as the Hughes or "H" stock of GM.)

Recently, the PBGC became part owner of US Airways Group (7 percent stock awarded to the PBGC) and expects similar compensation in the reorganization of United Airlines as the latter emerges from Chapter 11 protection early in 2006. If the share prices of these and other airlines in re-organization rise, and the PBGC sells shares at a profit, the current accounts and balance sheet of the PBGC look a little better than the black picture (actually, a picture with much red ink) painted by some Cassandras in the US Congress.

The PBGC, says the Congressional Budget Office (CBO), has a gap in obligations—with $62 billion in obligations and $39 billion in assets at year-end 2004. The gap could grow to at least $87 billion by 2015. (Are we already looking into the tumult of the second decade of the 21st century?) Some experts peg the long-term liabilities of the PBGC at numbers approaching $400 billion if private plans are dumped wholesale on the agency.

THE STEEL, AIRLINE, AND AUTO INDUSTRIES—WHAT SECTOR IS NEXT IN CREATING "PENSION FUND ANGST" FOR ALL INVOLVED?

The steel, airline, and auto industries—what sector is next in creating "pension fund angst" for all involved?

The focus on pension accounting begins as another important shift in corporate accounting takes place with the expensing of employee stock options (in accordance with FASB Statement No. 123R). The Walt Disney Company was quick out of the box in November to announce that it intends to begin expensing employee stock options in the fourth quarter of FY 2005—and that full year results for 2005 will be reported as though stock options had been expenses starting at the beginning of FY 2005.

No spin zone

The popular cable television host Bill O'Reilly calls his show the "No Spin Zone," apparently impressing at least some writers at *Business Week* who reported that the SEC will begin "cracking down on corporate spin," with a focus on "skimpy" or "misleading disclosures" in their annual reports. *Business Week* cautioned that the SEC is "pushing companies" to make the man-

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agement discussion and analysis (MD&A) section more complete and understandable, including:

- Telling investors the good, bad, and ugly about their business, and, in plain English;
- Focusing on key trends and events and their impact on liquidity, capital, revenues, and profits; and
- Explaining what the numbers really mean.

Editor Amy Borrus in Washington, DC wrote that the test case for "misleading explanations" will be that of Kmart, with the SEC bringing action against former executives (CEO and CFO) for 2001 quarterly reports. This, she says, is the latest sign that the MD&A section of quarterly and annual reports is to be "the SEC no-spin zone." (Cases were also brought against Coca-Cola Co. and Global Crossing.) The SEC initiatives in this area pre-date SOX mandates; remember the "plain English" initiative, as well as Reg FD? Now that the capital markets "are fixed," to note the new SEC chair, attention is being paid to "FFD": full and fair disclosure by corporate managers.

Make'em tell all

In the spirit of advancing more full and fair disclosure, Congressman Barney Frank of Massachusetts—the leading Democrat on the House of Representatives' Financial Services Committee—introduced legislation that would (if adopted) require public companies to include in their annual reports "complete and clear information about CEO pay, pensions, golden parachutes, use of corporate jets," and other management perks. Congressman Frank wants companies to tell shareholders their plans to recover bonuses, stock options, and other incentive compensation when [later proved] unjustified, such as when the value of the award was based on fraudulent financial results.

Former SEC Chairman William Donaldson began looking at executive compensation issues and appropriate disclosure (to be required), and the new SEC chair is expected to continue the focus, with a disclosure proposal coming early in 2006. We can be assured, with the intense focus on executive compensation by a growing number of institutional shareholders in the first half of decade "1/21," that this issue will not be going away soon. Watch for more versions of pay-for-performance plans coming forth from companies sensitive to public criticism on the compensation issue.

Also, look for social and ethical investors—such as the member organizations of the Interfaith Center on Corporate Responsibility (ICCR)—tying demands for improvements in certain corporate behaviors, policies, and practices to incentive payments for executives through their shareholder resolutions. ICCR members represent $110 billion in direct equity investments and influence $1 trillion or more in institutional investments, depending on the issue at hand. And executive compensation is a very big issue for faith-based and social investors as well as mainstream institutions.

Reading the SEC tea leaves

With the departure of SEC Chairman William Donaldson late in 2005, and the appointment of former Congressman Christopher Cox to the highest post at the SEC, there is much interest among capital markets managers, as well as corporate management and investors, in the future direction of the "top cop" on the securities beat. What kind of chair will Mr. Cox be? A tough enforcer of the rules? Easier than his predecessor on corporate and Wall Street offenders? A pro-business leader?

Some signals were sent by Chairman Cox at the annual gathering of the Securities Industry Association (SIA) in early November. He told the group that "our capital markets depend on investors' confidence . . . that their money will be safe from all but genuine market risks. For that reason, all of us here are comrades in our shared struggle against the financial outlaws of the 21st century." (He mentioned the corporate scandals affecting Enron, WorldCom, and Global Crossing.) Voicing his optimistic outlook, Chairman Cox said that "it's clear that investors' confidence in our capital markets is back . . . .[Thanks to the] persistent integrity of millions of truly honest and good

American men and women who populate the world of finance."

These accolades aside, Chairman Cox then addressed the work at hand for the immediate future: fraud and unfair dealing will always be with us, he noted, and there is much work to be done to "arrest this threatening behavior" before it does its worst damage. In focus for the SEC's boss: redoubling efforts on sound corporate governance, solid [financial] controls, and transparent financial and business reporting. SEC enforcement is the new chair's top priority, he informed the SIA members: "We are, first and foremost, the investor's advocate."

Two regulatory initiatives launched before his appointment will be supported going forward by Chairman Cox: the much-contested rules regarding the independence of mutual fund directors, and the rule regarding the registration of hedge fund advisors (which goes into effect February 2006). These rules will reshape the operating environment for advisors and hedge managers for the rest of the decade . . . and beyond. (Remember we are still operating under the Investment Company Act of 1940 as the primary rulebook for investment companies and mutual funds.)

As for the "financial burdens" of Sarbanes-Oxley compliance, there will be "fine tuning" of SOX and other rules to get (1) the maximum amount of investor protection at (2) the lowest possible cost to issuers.

One group that has the ear of the SEC and its chairman is the Advisory Committee on Smaller Public Companies; the group has made a number of recommendations to the SEC for reducing the financial burden on smaller cap firms.

Another SEC initiative that Chairman Cox views favorably is the adoption of XBRL (extensible Business Reporting Language) for data tagging, which the SEC views as helpful to investors, analysts, companies, exchanges, and other parties. "Interactive data can make the SEC a far more effective regulator," Cox explained, by focusing on preventing fraud, not just reacting to it. XBRL and XML (extensible Markup Language) will be key elements in future SEC operations and enforcement, and interactive data may even solve (he opined) the "seemingly intractable dilemma of different global accounting standards."

ANOTHER SEC INITIATIVE THAT CHAIRMAN COX VIEWS FAVORABLY IS THE ADOPTION OF XBRL FOR DATA TAGGING.

A farewell to the father of modern management

Ending on a personal note: The great management guru Peter F. Drucker passed on (at age 95) in November 2005. He was "revered as the father of modern management" for his many books, professional articles, and advice given to executives in various settings, including the classroom. One of his powerful books—*The Unseen Revolution: How Pension Fund Socialism Came to America*—was profiled in these pages several issues back (see the Nov/Dec issue of 2004), and the theories of "pension fund socialism" were then refreshed for the current generation of financial leaders.

After publication of that issue, this columnist received a gracious note from Professor Drucker—a "thank you" for reviewing the book and for bringing its keen observations to a new generation of finance professionals.

In 2002, Peter Drucker was awarded the Presidential Medal of Freedom and *Business Week* hailed him as "the most enduring management thinker of our time."

We leave you until next time with these "big ideas" Peter Drucker published just a few years ago:

> Following the information revolution, once again we see the emergence of new institutions and new theories [e.g., the EU, NAFTA, CAFTA] ... .there is no real precedent for the Citigroups, Goldman Sachses or ING Barings that have come to dominate world finance. They are not multinational but transnational. The money they deal in is almost totally beyond the control of any country's government or central bank.
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> ... The greatest changes are almost certainly still ahead of us. We can be sure the society of 2030 will be very different from that of today, and that it will bear little resemblance to that predicted by today's best-selling futurists . . . .The central feature of the next society . . . will be new institutions and new theories, ideologies and problems.

Always looking forward, Peter Drucker inspired managers (and emerging leaders) over the span of six decades of the 20th century. He firmly believed that the true heroes of the 20th century were the managers who guided business and social sector enterprises. Thank-

fully, his words and thoughts remain available to guide us in the 21st century as well—and especially through this first decade. •

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