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Financial Reporting Directions Drawn From the Top Governance Issues of 2005

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Benjamin Neuhausen and Rosemary Schlank of BDO Seidman LLP consider the future of financial reporting based on possible responses to shareholders' top 10 concerns of 2005.

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Proxy season 2005 is nearly finished, but the shareholder concerns that surfaced this year will likely determine the direction of financial reporting for some time to come. More than ever, investors are probing into complex issues involving accounting, taxes, and risk management. Though it seemed unthinkable a few decades ago, those once arcane issues are now close to taking center stage in the world of corporate governance. As this trend continues, it is revealing a provocative new vision of future financial reporting. Woven into that vision are signs that transparent reporting and sound tax management could join to form the kind of intangible asset that will distinguish well-managed companies in the post-Sarbanes-Oxley era. This article builds on those signs and looks ahead to provide a glimpse of what the future of reporting may hold and how companies may choose to respond.

To help identify the trends in governance and reporting, below are 10 loosely paraphrased requests drawn from the demands of shareholders in the 2005 proxy season.

(1) Be forthcoming in reporting executive pay that could be viewed as "stealth wealth."

Near the top of this year's list of governance issues are shareholders' demands for companies and directors to be more accountable for excesses in executive pay. An important concern is that companies may try to avoid controversy by lowering or freezing a CEO's salary while increasing other forms of undisclosed compensation (sources of "stealth wealth"). Fears about that sort of deception were heightened in a year marked by CEO ousters and reports of lavish severance and retirement pay or undisclosed perquisites.

Some forms of executive pay remain undisclosed because Securities and Exchange Commission rules require disclosures of benefits only if they exceed $50,000, and separate disclosure of perks only when valued at more than 25 percent of the total compensation. The SEC has said it is considering more stringent disclosure requirements for possible future rulemaking. In the meantime, public companies can respond to shareholder demands by voluntarily disclosing more details. Perquisites, retirement benefits, deferred compensation, total compensation, director compensation, and compensation paid to additional executive officers (beyond those currently required) all are potential areas of voluntary disclosures.

To be really leading-edge, companies can supply more details on a real-time reporting basis. For example, some companies have already begun to report on Form 8-K the entry into agreements, including at-will oral agreements or bonus arrangements, with named executive officers and other executive officers.

(2) Consider expanding the company's pay-for-performance reporting.

SEC rules already require companies to discuss correlations of executive pay with corporate performance. Under the SEC's guidelines, the proxy must include a compensation committee report addressing the company's executive compensation policies and practices, the basis for compensation paid to the CEO for the last completed fiscal year, and the relationship between executive pay and corporate performance. But that wasn't enough for some proxy advisers in 2005.

In an attempt to foster greater accountability, proxy advisers urged shareholders to ask if the compensation committee has indicated how it has improved performance. Some shareholder activists even recommended withholding votes from compensation committee members who didn't provide that information in a public filing.

Although the demands for answers to specific questions met with limited success, an increasingly popular response has been to voluntarily increase the length of the compensation committee report. Research reports showed that many companies took that step in 2005. The most common changes involved more disclosures about executive benefits and equity-based compensation.

(3) Explain how the company is adapting its investment plans to changes in tax or securities laws.

Recent studies show that many companies have more cash on hand. For companies with international operations, the American Jobs Creation Act of 2004 (the Jobs Act) may increase cash reserves still further, and shareholders typically want to know how the company plans to adapt its investment strategy.

International companies may choose to respond to shareholder concerns about the use of excess cash by providing voluntary disclosures about the expected use of any additional repatriated funds that might materialize as a result of Jobs Act tax incentives that encourage companies to return funds to the United States.

Companies that plan to use excess cash for mergers or acquisitions may choose to make additional disclosures to respond to concerns about fairness opinions. An important concern regards the potential conflict of interest on an opinion issued by an investment bank that also offers advice on the business combination. Companies can respond to those concerns by making voluntary disclosures along the lines of rule changes proposed by the NASD in 2004. The NASD's proposal calls for more disclosure of significant conflicts of interest by investment banks, along with the steps the firms are taking to counteract those conflicts.

(4) Be candid about actions taken in response to, or in anticipation of, changes in accounting standards.

Changes in accounting standards prompted an unusual level of shareholder concern in 2005, primarily as a result of the issuance of FASB Statement No. 123R, "Share-Based Payment," in 2004. Companies were not required to adopt the standard for 2004 financial statements, and it was reported that many were reconsidering their compensation strategies in anticipation of the required adoption date.

Statement 123R changes the accounting for transactions in which a company receives employee services in exchange for (1) the company's equity instruments or (2) liabilities that are based on the fair value of the company's equity instruments or that may be settled by the issuance of those equity instruments. The major change in accounting introduced by Statement 123R is to require that those transactions be expensed using a fair-value-based method. Because there are several enhancements or alternatives to stock options, such as restricted stock, performance plans, and cashless exercise features, shareholders want to know what management is planning to avoid or mitigate the accounting effects of the standard. Companies can respond to those concerns by being candid in reporting the actions they are planning to take and the reasons for taking them.

Candid responses about actions being taken in anticipation of other upcoming accounting changes can be more difficult. For example, shareholders may have been especially concerned about the company's use of aggressive tax positions because of a FASB proposal expected this summer. FASB is expected to propose that tax benefits for uncertain tax deductions or credits be recognized in the financial statements when they are probable of being sustained by the taxing authorities. Derecognition would occur when it is more likely than not that the position won't be sustained. Recognizing the potential effects on earnings, investors want assurance that the company is properly managing and accounting for its tax risks so there will be no unpleasant surprises if FASB's proposal is adopted into a final standard.

(5) Disclose the role of the audit committee in reviewing tax-related risks and services.

In the post-Sarbanes-Oxley world, audit committees serve as the shareholders' representatives, and an effective audit committee can help reassure investors that risks are under control. But recent developments may be causing shareholders to question whether the audit committee is fully engaged in reviewing tax-related risks and services.

First, there have been reports of companies with big differences between book and taxable incomes, signaling that those companies may be overly aggressive in reducing taxable income. Second, there have been reports of abuses of tax shelters, including some that may involve officers of the company. Those events have helped to elevate taxes to more of a boardroom issue, appearing on the agendas of audit committees. But shareholders may be unable to discern the audit committee's effectiveness without some disclosures about what the audit committee is doing to assess tax-related risks.

Also, the SEC has clarified the rules on contingent fees, and the Public Company Accounting Oversight Board (PCAOB) has proposed rules concerning auditor independence. Under the PCAOB's proposal, auditors would not be considered independent if they provide tax services that involve contingent-fee arrangements with clients or services that involve planning or opining on the tax consequences of some transactions. Auditors also would be prohibited from providing tax services to officers in a financial reporting oversight role. The effects of the proposal may not be obvious to shareholders without additional disclosures.

(6) Describe the company's code of business conduct and ethics.

Corporate codes of conduct have figured prominently in recent reform efforts. Section 406 of the Sarbanes-Oxley Act of 2002 requires that public companies institute a code of ethics for senior financial officers, and the listing rules of some exchanges have stricter requirements. Even if a company is not required to meet the stock exchange rules, shareholders may view the listing requirements as best practices and may question why their company's policies don't meet those strict standards.

To respond to shareholder concerns, companies may wish to make disclosures similar to those required by New York Stock Exchange rules that took effect in 2004, even if they're listed on other exchanges that don't require the same disclosures. The NYSE rules require that listed companies adopt and disclose a code of business conduct and ethics for directors, officers, and employees. And under the NYSE's rules, those codes must address some key areas and be available to shareholders, either on the company's Web site or in print, and must be referenced in the company's annual report filed with the SEC. The codes matter to shareholders because a good code of conduct can carry a lot of weight if a company is ever accused of serious wrongdoing.

Recently the trend has been to combine codes of conduct and compliance programs with the concept of social responsibility by stressing broad concepts of responsible business conduct, responsible business enterprises, and business ethics programs. Related disclosures might address human rights issues, such as nondiscrimination, forced labor, and child labor, and environmental concerns, such as global warming and the feasibility of investments in renewable energy sources.

(7) Develop and disclose a year-round shareholder communications process.

Shareholder questions are expanding beyond the boundaries of annual meetings and receiving more attention during the year because of several new developments that address a sense of frustration among shareholders that their views are not welcome or heard in boardrooms by their elected representatives.

The new developments include an SEC rule on communications between security holders and boards of directors that took effect in 2004. The rule requires that companies either establish processes for shareholders to send communications to board members or to explain why they have not done so. Also, revised NYSE listing standards require that companies disclose a method for interested parties, including shareholders, to communicate directly with either the presiding director of the board's executive sessions of nonmanagement directors or with the nonmanagement directors as a group. Even if a company is not listed on the NYSE, it may wish to consider developing and disclosing a similar process for year-round shareholder communications.

Companies can also disclose their compliance with emerging best practices found in a report issued by the National Association of Corporate Directors and the Council of Institutional Investors. Titled *Framework and Tools for Improving Board-Shareholder Communications,* it offers practical suggestions. Examples for boards include providing detailed contact information for the appropriate management representative and at least one independent director, and developing and disclosing communications policies covering all forms of communication, including in-person meetings, telephone calls, e-mail, and other written communications.

(8) Follow best practices for earnings guidance and Regulation FD.

In developing their communications policies, companies must keep in mind the SEC's Regulation Fair Disclosure, (Regulation FD), which prohibits selective disclosure of material, nonpublic information to one investor or selected groups of investors. That rule has proved frustrating to companies that are tracked by securities analysts and release earnings guidance. Research shows that the percentage of large companies that release earnings guidance has dropped from 72 percent in 2003 to 55 percent in 2004 -- a matter of concern to securities analysts, shareholders who rely on the reports of the analysts, and others who see it as an impairment of rights under the First Amendment.

Companies can help address those concerns by commenting on their compliance with best practices developed by the National Investor Relations Institute and the CFA Centre for Financial Market Integrity. Their report, *Best Practice Guidelines Governing Analyst/Corporate Issuer Relations,* suggests guidelines for the types of information that companies should disclose, depending on whether they choose to provide earnings guidance. Companies that provide guidance should supply the components of earnings (revenues, expenses, gains, losses, margins, earnings per share, and so forth), as well as a sensitivity analysis. Companies that don't provide earnings guidance should (1) provide and discuss five-year growth rate projections to ensure a long-term focus, (2) discuss the issuer's business cycle and relevance to the current quarter, and (3) discuss each quarter's contribution to the company's long-term strategy.

(9) Explain the extent to which shareholders are shielded from litigation and settlements.

The explosion of class-action suits in recent years has been a concern to shareholders. Some of the lawsuits were triggered by business and reporting failures that resulted in well-publicized trials of former executives. Increasingly, the media have been reporting large corporate settlements, often at the shareholders' expense.

Lawmakers have been reexamining the legal system governing tort actions. In early 2005, the Class Action Fairness Act was signed into law. It is expected to help curb future settlements of tort actions by making it easier for defendants to move many multistate class actions into federal court. But shareholders are still more vulnerable to damages and penalties than they would like to be.

As a result, plaintiffs in some class-action suits have pressured corporate directors to dig into their own pockets and pay personally for fraud they didn't commit or perhaps even know about. The two groundbreaking settlements in that regard involved alleged securities law violations at WorldCom and Enron. They set precedent for other plaintiffs to force corporate directors to make personal restitution for corporate misdeeds, despite legal indemnifications and directors and officers insurance, both of which can be tough to sort through. Although SEC rules require disclosure of indemnifications of officers and directors, the full indemnifications may not always apply, making it difficult for investors to discern the effect on the company's earnings and financial condition.

(10) Disclose factors that have a bearing on the independence of directors.

Another regulatory initiative that is having a profound effect on proxy voting is the NYSE and the Nasdaq's adoption in 2003 of rules about directors. Listed companies had to comply with the rules in 2004. The rules require that boards have a majority of independent directors. They also strengthen the definition of an independent director and the required duties of board committees. Because the listing rules demand a high level of involvement among directors, they have raised concerns that some directors may have overextended themselves by serving on too many boards.

To reassure shareholders, companies may choose to make disclosures about such matters as (1) the number of boards their directors serve on, (2) any fee arrangement that might be seen as a conflict of interest, (3) the length of the cooling-off period if a former CEO is appointed to the board, and (4) any relationship between a director and another individual compensated by the company who might meet the definition of a relative.

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