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BDO Seidman, LLP
Accountants and Consultants

May 2006

Financial Reporting

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Corporate Governance Update and Shareholder Questions – 2006

BDO Seidman, LLP prepared this *Financial Reporting* letter to help our clients anticipate and respond to the key governance issues of 2006.

Mounting demands for transparency in boardroom dealings are transforming the world of corporate governance. Here are the key trends to consider in 2006:

- Management is being pressured to balance short and long term plans.
- Directors are being pressured to balance monitoring and strategy.
- Hedge funds have become active in pushing companies for change.
- Internal control weaknesses and restatements continue to drive the need for audit committee effectiveness.
- Boards and investors are reacting to a year of record-breaking restatements.
- Shareholder litigation is focusing more on financial reporting and forecasts.
- Fines imposed by the SEC for accounting fraud have soared to record levels.
- Executive pay continues to be a flash point.
- Dozens of companies have voluntarily adopted majority voting for directors.
- Shareholders are withholding votes for directors at companies with poor compensation practices or ineffective audit committees.
- An SEC-led initiative for electronic proxies could soon open the door for companies to communicate more directly with investors.

To keep pace with the changing environment, this year's update provides more background on the current issues and the steps that companies can take to come to grips with these issues. Our traditional lists of timeless shareholder questions are presented as an appendix. We hope you find this approach useful.

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The Legislative and Regulatory Environment

Companies and their boards of directors must adapt to a changing legal landscape after a year of mega-settlements and soaring SEC fines.

Lawmakers and regulators are slowly bringing order to the complicated world of punishments and deterrents for corporate crime. But the changing legal and regulatory landscape adds to the complexities for management and directors, leaving investors with new reasons to ask old questions. At issue is how effectively companies are monitoring compliance with laws and regulations, preventing litigation and avoiding fines.

Shareholder Litigation

The legal landscape continues to evolve after a year of well-publicized mega-settlements of class action lawsuits and landmark court decisions.

Recent headlines have focused on settlements involving large companies, such as WorldCom and Enron. But studies show class action lawsuits have hit smaller companies as well, especially in high growth industries.

Earnings volatility and fraud are among the top reasons for lawsuits directed at smaller companies, and a common denominator among the lawsuits facing both large and small companies has been the allegation of misrepresentations in financial documents, such as SEC filings and press releases.

To gauge the full extent of the trends in shareholder litigation over the past decade, the Stanford Law School Securities Class Action Clearinghouse in cooperation with Cornerstone Research conducted a study of several thousand federal class action filings in calendar years 1996 through 2005.

The results showed that:

- The percentage of filings alleging misrepresentations in financial documents grew to 89% in 2005, up from 78% in 2004.
- The percentage of filings alleging false forward-looking statements climbed to 82%, up from 67% in 2004.

These findings suggest that shareholder litigation is becoming increasingly focused on financial reporting and forecasts.

Shareholder litigation is becoming increasingly focused on financial reporting and forecasts.

Two landmark court decisions have eased the impact of shareholder lawsuits and may help address questions about the prevention or outcome of litigation:

- In April 2005, the Supreme Court ruled that plaintiffs must prove their losses were due to fraud or corporate wrongdoing, rather than market conditions, such as an overall decline in the market. (*Dura Pharmaceuticals v. Broudo*)
- In March 2006, a Supreme Court ruling severely limited the viability of shareholder lawsuits brought in state courts by investors who say they were fraudulently lulled into continuing to hold stock rather than buy or sell it. (*Merrill Lynch v. Dabit*)

At the same time that corporate exposure to private securities litigation may have been easing a little, sanctions imposed by the SEC have been increasing.

SEC Fines and "Fair Funds"

Fines imposed by the SEC for accounting fraud have soared to record levels in recent years.

The Sarbanes-Oxley Act of 2002 empowered the SEC to levy fines in "Fair Funds" from which money is returned to defrauded shareholders. A key challenge for the SEC is how to levy a fine for an act committed years ago without unduly penalizing current investors.

In early 2006, the SEC agreed on a set of guidelines for basing fines on the following factors:

- The presence or absence of a direct benefit to the corporation as a result of the violation.
- The degree to which the penalty will repay or further harm the injured shareholders.
- The need to deter the particular type of offense.
- The extent of complicity in the violation throughout the corporation.
- The level of difficulty in detecting the particular type of offense.
- The extent of cooperation with the SEC and other law enforcement.

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Shareholders may want to know how companies are adapting and if the guidelines are useful in reducing uncertainty about penalties and encouraging good corporate compliance programs.

Other Laws and Regulations

Shareholders may also ask about the effects on the company of laws, regulations and government policies related to pension funding and immigrant workers.

- *Pension Funding*. During 2005, the White House called for tougher laws for pension plans. Bills introduced in Congress would require that employers pay more for insurance for traditional defined benefit plans. The pending legislation would also ensure adequate funding for workers' plans and rein in special executive pensions.
- *Immigrant Workers*. Faced with mounting concern about the immigrant workers who lack authentic working papers, the Secretary of the U.S. Department of Homeland Security has announced that his department will start filing criminal charges against employers caught hiring illegal immigrants. Currently, employers must request documents that prove a worker's identity and right to work, but they are not required to verify the authenticity of these documents.

The subject of how to deal with illegal immigrant workers is controversial. President Bush has called for accommodations for illegal immigrants, and the Senate is considering a bill (S.2612) that would offer most of the nation's 11 million to 12 million illegal immigrants a work permit and an opportunity to obtain U.S. citizenship.

Shareholder Questions

Relationships with legal counsel

- — Does the company have an in-house legal function?
- — Which outside firms are used to provide general legal advice and SEC counsel, if separate? Are any members of these firms also directors of the company?
- — Does the board have the ability to retain independent legal counsel for potential conflicts of interest on matters that management has a personal interest in, such as a retirement plan for senior executives?
- — Do both the in-house and outside counsel have direct access to the board?
- — Have any in-house or outside attorneys resigned or been terminated by the company during the last year? If so, what were the circumstances?

Compliance with laws, regulations and publicly known problems

- — How does the board monitor the company's compliance with legal requirements?
- — Do the directors feel they are adequately apprised of changes in laws and regulations, including federal securities laws, federal sentencing guidelines, stock exchange governance requirements, and state laws?
- — Do the directors feel they are adequately apprised of relevant court decisions?
- — Are the company's attorneys instructed to report any illegal acts to the board or the audit committee on a timely basis?
- — Has the board discussed any problems that were cited in security analysts' reports, press articles, or other media during the past year? What actions, if any, were taken in response to these matters?
- — Has the company had any difficulty maintaining its stock exchange listing?
- — Is the company in compliance with immigration rules and regulations? How is this compliance monitored?
- — Does management have adequate policies and procedures in place to ensure that information collected about the company's customers, vendors, or other trading partners remains private?
- — When is the last time the directors participated in compliance training?

Prevention of problems and penalties

- — Has the company taken steps to prevent fraudulent financial reporting or other corporate wrongdoing?
- — Does the board regularly review to ensure the CEO and senior management are setting a "tone at the top" that stresses legal compliance?
- — Has the company taken all necessary steps to minimize the fines or sentences that might be imposed in response to fraudulent financial reporting or other corporate wrongdoing?

Shareholder Questions (continued)

- How does management ensure that no illegal immigrants are employed by the company or its contractors?
- Has the company considered including alternative dispute resolution clauses in contracts and other agreements with its customers, suppliers, and employees?
- Does the company conduct periodic assessments of the strength of its patent portfolios?
- Has the company taken appropriate legal actions to protect its patents, trademarks, and other proprietary property?
- How does the company protect the integrity of existing patents, technology, and intellectual property overseas?
- Is the company prepared for patent or anti-trust challenges?
- Does the company have a "crisis plan" to deal with big mistakes and crises such as investigations, restatements, or research reports that get negative press?

Investigations and pending litigation

- Is the company under investigation by any Federal or state regulatory agency? What issues are involved, and how will the issues be resolved? When will the investigation end?
- Has the SEC or any other regulatory body investigated the company or its management or questioned any of its reporting practices? What is the status of the matter, and what is management doing to resolve the issues?
- If the company operates in a regulated industry, has it been subject to a regulatory examination during the past year? What were the results of the examination? How is management planning to address any problems identified?
- Does the company have a policy of self-reporting and cooperating, should an SEC or other regulatory agency initiate an investigation?
- Were any of the company's products taken off the market due to decisions by the FDA or other government agencies? What is the impact on revenues and earnings?
- Is any government agency investigating the company's importing and exporting practices? If so, what is the status of the investigation?
- What matters are currently being litigated? What is the likely outcome?
- Will damages, if any, from pending litigation be covered by insurance? Are there any issues about insurance coverage?
- Has the company adequately reserved for liabilities from pending litigation?
- If the company is a plaintiff in any actions, what are the damages claimed and how long will it take to resolve the suits?
- What expenses were incurred for legal fees, and what amounts were paid in settlements this year and last year? What legal services were provided and by whom?

Other legislative and regulatory matters

- Is the company having difficulty obtaining general liability insurance or insurance for directors and officers?
- How much is it costing the company to comply with Section 404 of the Sarbanes-Oxley Act of 2002?
- In light of the costs of the Sarbanes-Oxley Act, would the company consider plans to deregister or go private? If so, how would current shareholders be assured that they will receive a fair price?
- How will the company be affected by the proposed changes in funding requirements for pension plans?
- Why has it taken so long for the company's patent applications to be approved? Why does it take so long for FDA or other approvals to be obtained? What is the likely impact on sales and earnings if they are (or are not) obtained?
- Does the company employ lobbyists to influence Congressional action? Which matters are of interest to the company and how much is being spent on lobbying efforts?
- Did the company adopt or amend any retirement plans this year? What were the costs or savings?
- Does the company limit the amount of its own stock that may be held in retirement plans?

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Boards of Directors

Demands for objective oversight and effective monitoring of corporate performance are raising questions about many facets of directors' roles and responsibilities.

In the wake of the financial scandals that rocked the corporate world earlier in the decade, demands on boards of directors have continued to escalate, and accountability to shareholders continues to be a major concern. These issues are affecting many facets of directors' roles and responsibilities, ranging from elections, resignations, independence and pay, to open doors and effective self-evaluations.

Elections of Directors

The SEC has backed off a controversial proposal that would have required companies to allow qualified shareholders to gain access to the proxy ballot to nominate directors.

But voluntary reforms in corporate practices for electing directors are making significant headway, signaling a powerful shift in U.S. corporate governance.

Dozens of companies voluntarily adopted majority voting practices in the past year in response to shareholder resolutions and emerging legal developments. Labor unions, pension funds, and institutional investors have sponsored resolutions urging companies to adopt a majority voting system for election of directors. In addition, the Committee on Corporate Laws of the American Bar Association released proposed amendments to the requirements for plurality voting systems in the model business corporation act that has been adopted by most states.

Under the *plurality* voting system, there is no way for a shareholder to vote against a director, and withheld votes have no effect. As a result, in an uncontested election a director nominated by management can be elected on a minority of votes or even a single vote.

In contrast, although there are variations in the ways it is being adopted, a *majority* voting system will typically take into account withheld votes. This technique gives shareholders more power to oust directors.

Dozens of companies voluntarily adopted majority voting practices in the past year.

The movement took root in June 2005, when Pfizer amended its governance principles to allow majority voting. Under Pfizer's approach, if a majority of votes cast for a director are marked "withhold," the director must submit his or her resignation, and the board then considers how to respond. Wells Fargo uses a more stringent variation, requiring that a director submit his resignation if more than half the shares in public hands "withhold" support.

The full impact of these changes on director elections and decisions made by directors is not yet clear. If a company has a diversified investor base, it may be hard for investors to rally support for a broad-based campaign to oust a director or extract a concession from management. But the growth of web-based communications and websites of proxy advisors could have significant and far-reaching consequences. More information is available in "A Majority Voting Primer" released in 2006 by the Council of Institutional Investors (http://www.cii.org/policies/MajorityVotingPrimer.pdf.)

Independence of Directors

Notwithstanding improvements made in recent years in determining and disclosing director independence, proxy advisors are still challenging director independence, and the New York Stock Exchange (NYSE) expressed dissatisfaction with disclosures in this area during 2005. As a result, the subject has gained publicity and may be on the minds of shareholders of any public company, even if the company is not listed on the NYSE.

To remedy the perceived weaknesses, the NYSE filed proposed amendments to its rules with the SEC and issued comment or warning letters to companies whose proxy statement disclosures could be improved.

The two main areas for improvement involve independence criteria and disclosures. The NYSE provides bright line tests for determining director independence. These tests include such matters as whether the director is an employee of the company or its law firm. Just meeting the bright line tests is not sufficient under NYSE rules. The company

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must also make an affirmative determination based on all the facts and circumstances that the director has no material relationship with the company, and it must disclose the basis for that assessment. The Exchange found some companies were relying solely on the bright line tests and/or not disclosing their other standards.

The NYSE's proposed rules are at http://www.nyse.com/pdfs/NYSE-2005-81.pdf.

Overboarded Directors

Because of the escalating demands on directors, investors may be concerned if the directors of their company also serve on boards of directors of other companies. For example, Institutional Shareholder Services (ISS) adopted a policy in 2006 of withholding votes for CEOs who serve on more than three boards including their own (the votes are withheld at the companies not headed by the CEO). ISS also withholds votes for non-CEO directors who serve on more than six public company boards.

Directors' Resignations

SEC Release No. 33–8400 requires certain disclosures if a director has resigned since the date of the last annual meeting of shareholders or refuses to stand for reelection because of a disagreement with the company. The required disclosures include a brief description of the disagreement. The company must also attach any written correspondence from the director concerning the circumstances surrounding the director's resignation.

In several well-publicized cases, directors have resigned noisily citing disagreements over executive pay practices and other matters of governance. These incidents may remind shareholders to question the reasons for any director's resignation or refusal to stand for re-election, even if the director goes quietly.

Pay for Directors

A novel idea that surfaced in proxy season 2006 is an "all-or-nothing" pay plan for directors adopted by the Coca-Cola Company. Under this plan, the directors will receive payment for their services only if the company meets certain performance targets for a three-year period.

This plan adds a whole new dimension to the concept of performance-related pay for directors. Some critics say it could make directors less independent and less inclined to question risky or unethical decisions by executives. Others point out the model would not work in a company whose directors are not independently wealthy. Neverthe-less, the approach may rekindle shareholder interest in all kinds of pay-for-performance schemes for directors.

Open Doors for Directors

Conceptually, directors serve as the "eyes and ears" of the shareholders, but this can be hard to do in practice when the directors' main contacts are with the CEO and top management.

As a result, companies have been experimenting with more "open access" plans to assist directors in their monitoring role. For example, directors of companies may be encouraged to visit stores or factories unaccompanied by top management. Another technique is to appoint a vice president for governance whose responsibilities include answering questions from directors and opening doors for them within the company to give them unfettered access to facts and people.

Board Evaluations

Self-assessments are mandatory for New York Stock Exchange companies, and other companies may conduct these evaluations voluntarily. However, there is diversity of practice in many important aspects of the evaluation processes.

Key areas of difference involve decisions as to how the assessments will be done, (questionnaires or interviews), who will be involved (internal people only or outside consultants), what issues will be covered, whether the entire board will be evaluated or just certain committees, and what will be disclosed to shareholders.

Perhaps of necessity, shareholder communications about board evaluations tend to be boilerplate and lacking in detail. Although these types of evaluations provide useful input for the boards themselves, they are less likely to provide either helpful or comparable information for investors. But this may not stop shareholders from asking about the results, and companies should be prepared to respond to these questions.

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Shareholder Questions

Elections and resignations of directors

- If the company has not already adopted majority voting for directors, why not?
- If the company has recently adopted majority voting for directors, what is the expected effect?
- Has consideration been given to cumulative voting for the election of directors? (Cumulative voting entitles shareholders to as many votes as the number of shares they own multiplied by the number of directors to be elected.)
- What was the attendance record of each director at board meetings and board committee meetings last year?
- Why aren't there more independent directors on the board?
- Does the board have a nominating or corporate governance committee composed entirely of outside directors?
- How many directors are women or members of minority groups?
- What actions are being taken to ensure diversity on the board?
- Are all directors shareholders? Does the company encourage directors to own shares in the company?
- Do any directors serve on multiple boards? How many boards?
- What can you tell us about the reasons for directors' resignations or refusals to stand for re-election?
- If a director resigned due to a disagreement, what is being done to address the reason(s) for the disagreement?

Independence of directors

- How does the company assess and monitor the continued independence of board members?
- What are the compensation arrangements for directors? How much are directors paid for attending board meetings? What perks do directors receive?
- Did any directors buy or sell significant amounts of company stock or exercise a significant amount of stock options during the year? If so, why? Given the outlook for the company's future, why did these directors sell or buy stock?
- What is the full extent of any dealings between any of the directors and the company during the past X years?
- Has the company employed or paid any fees to relatives of any of the directors?
- Has any outside director made recommendations to management regarding the possible employment of any individuals? How are possible conflicts of interest avoided in these situations?
- Has the company or any of its senior officers made significant donations to charities with which board members have significant involvement?
- How are potential conflicts of interest identified and monitored?
- Do directors sign conflict-of-interest statements prior to their appointments to serve?
- Are any of the directors also board members of companies that either compete or do business with the company?
- Did any board member abstain from voting as a result of a conflict of interest? If so, what were the circumstances? What can be done to avoid conflicts in the future?

Activities of the board of directors

- How often does the board meet? Where were the meetings held?
- Are executive sessions of non-management directors held regularly?
- What were the major areas addressed at the board level this past year?
- What actions has the company taken to open doors for directors to give them access to people below the CEO and senior management team?
- Does the board ever disagree with management? Were there any instances where the board rejected a course of action proposed by management?
- Does the board play a significant role in strategic planning? If a significant shift in strategy is contemplated, is the board consulted before final decisions are made?
- Are there separate boards of directors for each subsidiary? Are the separate boards encouraged to act independently from the parent company? Are the costs of separate boards justified by the benefits?
- Does the company indemnify directors in the event litigation arises which relates to possible conflicts of interest or negligence of the board? Does the company provide D&O liability insurance to members of the board?
- What factors are considered in the selection process for the chairman of the board?
- Has the board considered separating the roles of chairman of the board and chief executive officer?
- Did independent directors review and sign the annual report filed with the SEC? Did any directors refuse to sign?
- Do the directors receive training?
- How is the company ranked on corporate governance scorecards?
- Has the board developed corporate governance guidelines?
- When is the last time the board did a self-assessment? What were the results?

Executive Compensation

Lavish severance packages, lack of disclosures about perquisites and tax gross-ups, "backdating" stock options – all can raise questions about executive pay.

2005 was an epic year for fallen CEOs, including some ousted by the very boards they headed. Their fates and their severance packages caught the public's eye, and the resulting publicity may trigger questions at annual meetings. At the same time, investors became increasingly concerned about poor compensation practices, "backdating" stock options, clawbacks, and disclosure practices, especially regarding the parts of executive pay that are hidden from proxy statements and public reporting.

Severance Packages

Severance packages for senior management were very much in the spotlight again during 2005. These payouts can seem lavish compared with what others earn, even though boards must make competitive offers to attract talented executives. This is not a new issue, but it has been exacerbated due to the changing legal landscape and growing demands for accountability of boards. This environment has created so much uncertainty that directors may feel pressured into making changes at the top to avoid allegations of corporate malfeasance and boardroom acquiescence.

One important development this past year was the ruling by a Delaware court that the Disney board would not be held liable for approving a severance package for the company's former president. But this ruling sends a mixed message because of the tone set by the judge when he agreed the case could go to trial.

In effect, by allowing the case to go to trial, the judge said that directors could be held personally liable for making a bad compensation decision, even if they do not benefit personally from the decision. As a result, the key measure of directors' culpability today appears to be one of failing to act in good faith and live up to their fiduciary responsibilities.

In response to these developments, shareholders may question whether the board is considering any actions to limit excessive severance packages. Possible steps include the following:

- Directors may incorporate into employment contracts for CEOs reasons why the executives can be terminated without severance pay. Such reasons may include indictments for certain felonies (a lower standard than convictions) and refusal to provide testimony or cooperate with an investigation.
- Companies may voluntarily elect to seek shareholder approval for certain severance agreements. For example, Coca-Cola is one of several companies that have agreed to seek approval if the payout exceeds 2.99 times the sum of the executive's annual base salary and bonus. The 2.99 multiple has been suggested in shareholder resolutions. It falls just short of the maximum tax-deductible severance package in a merger or acquisition. For simplicity, companies may use the same maximum for all severance packages.
- In extreme circumstances, CEOs may take the initiative by accepting a position without a contract, or even voluntarily giving up pay. For example, one CEO reportedly gave up agreed-upon pay after the news of his employment contract and the severance pay for the departing management team were released at the same time, resulting in a public relations challenge.

Poor Compensation Practices

Several institutional investors have developed voting policies based on well-defined lists of "poor compensation practices." In effect, these policies allow investors to discourage compensation practices by withholding votes from compensation committee members who approve those practices.

Shareholders discourage "poor compensation practices" by withholding votes for compensation committee members.

Near the tops of the emerging lists of poor compensation practices are tax gross-ups. These payments may be considered a form of "disguised compensation" because they don't require separate disclosure in proxy statements.

Typically, payments for tax gross-ups are made to executives to cover personal income taxes on base pay or perquisites that are treated as income by the Internal Revenue Service. The payments may also consist of excise tax gross-ups on

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"golden parachute" payments for executives who lose their jobs in mergers.

The lists of poor compensation practices are still evolving. For example, a list recently compiled by Institutional Shareholder Services (ISS) includes employment contracts containing excessive severance provisions.

The list of poor compensation practices prepared by ISS also includes the following:

– Excessive perks that dominate compensation.
– Significant bonus payouts without justifiable performance linkage.
– Performance metrics that are changed during the performance period.
– Overly generous Supplemental Executive Retirement Plans (SERPs).
– Overly generous new hire package for a new CEO.
– Internal pay disparity.

ISS adds that poor disclosure, the absence or non-transparency of disclosure, and poor design of compensation payouts compound the problems of egregious pay practices.

"Backdating" Stock Options

Stock options have traditionally been an area of concern to shareholders. This year, investors are especially concerned about stock option awards due to SEC investigations into an alleged practice known as "back-dating." The allegation is that some companies granted options on one date but used hindsight to choose an earlier date with a lower stock price as the stated grant date.

The SEC's investigations were precipitated by academic research that examined thousands of companies and found a few with odd patterns of stock movement around the dates of grants. Those companies showed recurring patterns of option grants dated just before a rise in the stock price. The likelihood of such recurring patterns occurring by chance or luck is probably negligible.

The implications of these studies are of concern to shareholders because they indicate that boards of directors might have allowed the backdating of grants, either deliberately or inadvertently.

One way to address concerns about the potential for backdating is for the compensation committee to make it a policy that all grants are awarded at the same times each year.

Disclosure Practices

Some companies continue to voluntarily improve disclosures about executive pay in response to shareholder questions and a rule-making initiative underway at the SEC.

The SEC has released proposed rules that, if adopted, would require companies to provide better disclosures about the various elements of executive pay. For example, more disclosures would be required about retirement and post-employment benefits including SERPs, deferred compensation arrangements including all of the interest paid on executives' accounts, and executive perquisites including dividends paid on restricted stock.

The proposed rules would also require a new "compensation discussion and analysis" report to be included with proxy statements. This report would replace the current compensation committee report and would provide more disclosures about how pay for senior executives is determined, especially under pay-for-performance plans. The details might include the identity of any outside consultants hired and the specific performance metric used, for example, earnings per share.

An important difference between the current compensation committee report and the proposed new report is that the former is "furnished" while the latter would be "filed." That increases a company's liability for misleading statements. In addition, CEOs and CFOs would certify that the statements are true.

The proposed rules would also require a total compensation table that would include all forms of compensation for the highest-ranking executives. This table would, for the first time, require companies to report a dollar value for stock options side by side with salary, bonus, restricted stock and other forms of compensation, so investors can quickly and easily grasp the big picture of how much top-ranking executives are paid.

The SEC's rules are proposed, not final, and changes are still possible. But the proposed rules are already prompting companies to enhance disclosures, and institutional investors are using the proposed rules as a basis for drafting minimum disclosure policies for the 2007 proxy season.

Some activists are also pushing for greater shareholder say in more forms of executive compensation. Currently, companies must allow shareholders to vote on stock plans and certain types of tax-advantaged performance-based plans. Shareholder resolutions submitted in the 2006 proxy season would expand this power to other forms of compensation.

"Clawbacks" of Bonuses

A final issue that may be of interest to shareholders following a year of record restatements is the possibility of pay-backs (also known as clawbacks) of bonuses paid to CEOs and CFOs based on performance targets met in financial statements that were subsequently restated for noncompliance with financial reporting requirements These paybacks are required under Section 304 of the Sarbanes-Oxley Act.

Shareholder Questions

Oversight of executive pay

— How is executive compensation determined? Which matters are put to a shareholder vote?
— What benefits are payable to officers in the event of termination? Has the board taken, or is it considering, any actions to limit excess severance packages?
— Does the company pay tax gross-ups on any elements of executive pay? If so, which elements and how much?
— How does the company justify the differential between its highest-paid executive and lowest-paid worker?
— Is officers' compensation comparable to that of similar companies? Is there a ceiling on officers' compensation?
— Does the company use outside executive compensation consultants? If so, who?

Pay for performance

— What correlation is there between executive compensation and the market price of the company's stock?
— What steps has the company taken to ensure management pay is tied to performance?
— Is compensation based on subjective factors, a specific formula, or other objective criteria? Has the company changed the formula during the performance period?
— Why is such a high percentage of total compensation paid annually as opposed to long-term or performance-oriented awards? Is the company considering making long-term compensation a larger part of total compensation?
— If the company has restated earnings, have all related bonuses been recovered?

Disclosures about executive pay

— Are there any forms of retirement benefits, perquisites, or deferred compensation that are not disclosed in public filings?
— Are there any undisclosed at-will oral agreements and/or bonus arrangements with senior officers of the company?
— Has the compensation committee reported on how they have improved the company's performance?
— Does the company have any special executive compensation agreements that are triggered in the event the company becomes the target of an unsolicited takeover or merger offer (i.e., "golden parachutes")? If yes, why does management believe these arrangements are in the best interest of the company and its shareholders?
— How did the company choose which companies to include in its peer group index for stock performance? Why was or wasn't Company X included? Why has the company's stock underperformed relative to the market or peer group index?
— Has the company taken any actions to give executives' pensions greater protection than pensions of other employees in the event of bankruptcy?
— To what extent are incentive stock options used to compensate management or other employees? Does the company have an employee stock ownership plan (ESOP)? What are the advantages of the ESOP and is it effective in increasing shareholder value? Are sales of company stock restricted by the plan?

Equity-based plans

— If not already adopted, when does the company expect to adopt the fair value method of accounting provisions of FASB Statement 123(R), *Share-Based Payment*, to account for employee stock options? Is the company considering any changes in compensation strategies as a result of the new accounting standard?
— What procedures are in place to guard against backdating of option awards?
— Do any of the company's equity-based compensation plans have high burn rates relative to industry averages? (The burn rate is the total number of equity awards granted in any given year divided by the number of common shares outstanding.)
— Does the company plan to issue additional stock options to employees or other insiders? How much earnings dilution will existing shareholders experience, and what factors are considered in deciding how many options are granted and at what price to which executives?
— What portion of outstanding options is underwater? Does the company expect the options will be back "in the money" soon?
— Has the company issued, or is it considering issuance of, transferable stock options (TSOs), either one-time or ongoing?
— Did the company accelerate the vesting of any stock options prior to its adoption of FASB Statement 123(R)? Were the reasons clearly disclosed in the company's annual report?

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Audits and Audit Committees

The risks and consequences of gaps in internal control can be concerns to investors, pushing audit committees ever further into the public spotlight.

Audits and audit committees are in the spotlight again this proxy season, thanks to the risks and consequences of uncovering gaps in internal control under Section 404 of the Sarbanes-Oxley Act. Audit committees are working longer and harder to avoid mishaps, and investors are coming to the realization that ineffective audit committees can be a material weakness in a company's internal control process. New rules for auditor independence can also trigger questions from shareholders.

Internal Control Reporting

The vast majority of companies who qualify as "accelerated filers" filed reports in 2005 that were free of any material weaknesses. Among those that received adverse opinions, the following trends were noted:

- Studies show stock prices sometimes have dropped after companies have announced material weaknesses in their internal controls or delayed their filings as a result of efforts to comply with Section 404 of the Sarbanes-Oxley Act.
- Compounding the immediate effects on stock prices and filings, a material weakness can cost a CFO his job, adding management turnover to the risks and consequences.
- Analysis of the most common reasons for material weaknesses indicates the top factors are insufficient or unqualified accounting personnel, material year-end adjustments proposed by the external auditors to correct misstatements, and issues related to technology, such as access to data or segregation of duties.
- A breakdown of material weaknesses into specific accounting topics shows the most common areas of weakness were accounting for income taxes and revenue recognition.

The costs of complying with Section 404 have been an area of concern to shareholders and management alike, as companies staffed up and incurred costs to document controls, address deficiencies, and interpret new guidelines. Smaller companies have been especially hard hit by costs of compliance during the past few years, as evidenced in the following studies and reactions:

- Data maintained by a Standard & Poor's unit shows the average cost of an audit tripled for the S&P small-cap 600 and S&P mid-cap 400 companies from 2001 to 2004 as the provisions of the Sarbanes-Oxley Act kicked in.
- The cost-benefit equation for smaller companies has been hotly debated in recent years. The SEC is assessing the recommendations of a special panel appointed to study the issues.
- Comments received to date by the SEC indicate the Sarbanes-Oxley Act has reduced companies' ability to pay dividends, restricted the research coverage for small cap companies, and prompted shareholders to question whether the adverse effects on profits indicate problems with management.
- Comments received by the SEC also indicate an increase in shareholder activism targeted at smaller companies, as investors are now holding management accountable for controls that were not visible before.

As a result, shareholders may inquire about diverse areas ranging from controls, company preparedness, and board effectiveness, to the justification for the costs of compliance.

Audit Committees Effectiveness

The new requirements have resulted in an increased emphasis on the monitoring aspects of the audit committee's role. This may entail more frequent and longer meetings for audit committees. Some are meeting monthly now as opposed to quarterly. Their agendas involve meeting with auditors, reviewing controls, and increasingly they are reviewing financial statements before the statements are issued.

The new requirements have resulted in more frequent and longer audit committee meetings.

Many aspects of the audit committee's role have become more complicated now that financial audits are combined with internal control reporting and attestation. Proxy advisors may recommend withhold votes from audit committee mem-

bers if a material weakness rises to a level of serious concern, if there are chronic internal control weaknesses, and if there is an absence of established effective control mechanisms.

Because the stakes are so high, investors may want some feeling of comfort or assurance that no material problems have arisen throughout the year. Professional standards do not allow auditors to provide such assurance prior to the completion of an audit. Instead, shareholders must look to management and the audit committees to provide oversight of internal control audits.

Given the critical role of the audit committee, it is not surprising that an ineffective audit committee can, by itself, constitute a material weakness. For this reason, evaluations of audit committees have taken on increased significance.

One measure of audit committee effectiveness is whether the committee is performing all the duties listed in its charter. Other measures can be found in PCAOB Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statement*.

Under AS 2, auditors consider the following when assessing an audit committee's effectiveness:

- Independence from management.
- Clearly articulated responsibilities, typically in an audit committee charter.
- Effective interaction with the external auditors, internal auditors, and key members of management.
- Asking the right questions that demonstrate an understanding of critical policies and estimates.
- Responsiveness to issues raised by the auditors.

In addition, shareholders may want to know if any self-assessment reviews have been conducted and, if so, with what results.

Key measures of audit committee effectiveness are found in AS 2, and self-assessments.

There is no shortage of checklists and questionnaires to help audit committees assess their effectiveness. But experts have cautioned this should not be an exercise in box-ticking.

Some of the most effective self-assessment techniques include probing open-ended questions such as "How can we improve our meetings?" and "How can improve our interaction with management and/or the external auditors?"

Auditor Independence

Notwithstanding the strengthening of rules and standards in the post-Sarbanes-Oxley era, shareholder questions about auditor independence may continues to surface. Shareholders may also ask about the effect on auditor independence of the PCAOB's new ethics and independence rules concerning tax services, and contingent fees. Specifically:

- Auditors are prohibited from accepting fees contingent on the results of judicial proceedings or the findings of governmental agencies.
- Auditors are prohibited from providing tax services to individuals with a financial reporting oversight role at audit clients.
- Auditors are prohibited from marketing, planning or giving an opinion in favor of the tax treatment of certain types of potentially abusive tax transactions.

The SEC approved the PCAOB's auditor independence rules in April 2006 with varying effective dates and with varying transition requirements for the different provisions.

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Shareholder Questions

Internal control reporting – Compliance (Accelerated filers)

— What were the costs of complying with Section 404, and what is the company doing to ensure maximum benefits are derived from these costs? How did the costs change in year 2?
— Does the company expect to be subject to the requirements for "large accelerated filers" in 2006?
— If a material weakness was identified, is it a pervasive issue across the company? Or is it limited to a specific location or account? What is management doing to remediate the weaknesses in these areas?
— Were any material weaknesses identified but not reported because they were corrected before year-end?
— How was materiality evaluated? On the basis of impact on the income statement, balance sheet, or both?
— Were there any disagreements with the auditors on the evaluation of significant deficiencies or material weaknesses?
— Were audit adjustments identified but not recorded? Did the audit committee concur with the decision not to record the adjustment? How did the discovery of the adjustment affect the assessment of internal control?

Internal control reporting – Readiness (Non-accelerated filers)

— What is the status of the SEC's reevaluation of the costs and benefits for smaller public companies? How would the company be affected by the changes proposed by the SEC's advisory committee on smaller public companies?
— What is management's best estimate of the cost of compliance? Will it affect dividend payouts or spending decisions?
— Will the company be ready to perform its annual evaluation, testing, and reporting on the effectiveness of its internal financial reporting controls by the deadline of the new SEC rules? Will outside resources be used?
— Has the company established policies and procedures for disclosing internal accounting control deficiencies and frauds identified to the auditors and the audit committee?
— Has the company implemented the recommendations of the Treadway Commission or the related Committee of Sponsoring Organizations in assessing and documenting its internal controls? If not, what actions are being considered that would be responsive to such recommendations?

Fraud prevention and detection

— How do the financial statement audit and the 404 audit consider the risk of fraud, including both financial statement fraud and misappropriation of assets?
— Did the Section 404 assessment identify fraud on the part of senior management?

The audit committee

— How often did the audit committee meet last year?
— Has the audit committee performed a self-assessment in the past year? What changes were made?
— Does the company believe the tasks being performed by the company's audit committee are in compliance with the Sarbanes-Oxley Act and related SEC rules and applicable stock exchange requirements?
— How does the audit committee monitor the nature and extent of non-audit services performed by the external auditors?
— Has the audit committee established safeguards to ensure the external auditors perform no prohibited services?
— Is the audit committee overseeing the company's preparations for internal control reporting under Section 404 of the Sarbanes-Oxley Act?

Relationship with external auditors

— How have the auditors' fees changed as a result of Section 404? How are they expected to change in the future?
— What factors are considered in the evaluation of whether the external auditors are independent?
— Did the company enter into any arrangements with the auditor involving contingent fees?
— Did the auditor provide any tax services to the company or its executive officers of the type that would impair the auditor's independence under the PCAOB's rule on ethics and tax services?
— Has the company experienced any significant changes in the relationship with the external auditors under the new system of PCAOB oversight?

Understanding the Financial Statements

Material weaknesses in internal control, SEC issues sweeps, and complexity of accounting standards resulted in a record number of restatements in 2005.

Following a year of record-breaking restatements of prior years' financial statements, shareholders will likely have questions about the reasons for past restatements and the likelihood of future restatements. Weaknesses in internal control, complex accounting standards, and "issues sweeps" by the SEC have all been contributing factors.

Restatements and Controls

To put the number of restatements in perspective, statistics compiled by proxy advisor Glass-Lewis indicate that restatements were at an all-time high in 2005, affecting one in every 12 public companies.

One reason for these restatements is an underlying weakness in internal controls. Approximately half the companies filing restatements also reported material weaknesses in internal control. Smaller public companies (non-accelerated filers) have not yet evaluated their internal controls under Section 404. If the correlation between material weaknesses and restatements holds true for these companies, then the trend toward more frequent restatements may continue in 2006.

Another reason why restatements may continue in 2006 is a new accounting standard known as FASB Statement No. 154, *Accounting Changes and Error Corrections*. Under Statement 154, companies that make changes in their accounting principles must restate their prior year financial statements as if the company had always used the new principle.

As a result of Statement 154, restatements will likely be required more often for new accounting standards. Unless the FASB specifically decides that another transition method is preferable for an individual standard or EITF issue, it will require a restatement.

Companies will need to communicate these kinds of restatements carefully so that shareholders understand that restatements related to changes in accounting principles are unrelated to material weaknesses.

SEC Issues Sweeps

Another significant factor adding to the number of restatements in 2005 was the desire on the part of companies to avoid being caught in an "issues sweep" in which regulators identify an issue with one company, then expand their investigations to other companies likely to be affected by the same issue.

The issues that sparked waves of restatements in 2005 included industry-specific reviews, (e.g., oil and gas issues). But there were also cross-cutting issues, such as accounting for leases. The resulting restatements and adjustments did not follow a change prescribed by an accounting standard-setter or regulator, and they seemed to take many companies and investors by surprise.

If a company is targeted in an SEC issues sweep, management may be required to respond to broad information requests without any indication of wrongdoing. This was one of several areas for improvement cited by the U.S. Chamber of Commerce in its March 2006 "Report on the Current Enforcement Program of the Securities and Exchange Commission."

In its report, the Chamber of Commerce recommended that the Commission appoint an Advisory Committee to study its enforcement processes. The report is available at http://www.uschamber.com/publications/reports/0603sec.htm.

Complex Accounting Standards

Another reason for the increased number of restatements is simply misapplication of complex accounting standards. For example, in early 2006, there were a number of restatements for misapplications of the "shortcut" method of accounting for hedges.

Simply put, hedge accounting allows companies to reduce earnings volatility through the use of derivative instruments. But this method requires that companies understand and meet strict criteria to ensure the hedges are effective and any losses are reported on a timely basis.

The FASB has agreed to work with the SEC toward a goal of reducing complexity in accounting standards.

SEC Comment Letters

To help companies understand its concerns about accounting and disclosure issues, the SEC has begun to publish its company-specific comment letters on its Web site.

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Some common themes from recent comment letter are as follows:

- Companies should clearly explain their accounting policies for recording uncertain tax positions.
- Disclosures regarding pension liabilities should be robust and should include disclosure of the assumed discount rate.
- Disclosures about non-GAAP measures (figures not defined in generally accepted accounting principles) should clearly explain why the measure is relevant.
- Considerations involved in determining whether elements of revenue should be presented gross or net should be disclosed to investors.
- Companies should pay close attention to the impact of redemption features on the classification of a financial instrument as a liability or temporary equity.
- Disclosures about convertible instruments should indicate whether the conversion feature affects earnings per share.
- Cash flow statements should provide insightful analysis, including discussion of the reasons for changes in cash flows.
- Management's discussion and analysis should provide an overview of the company through the eyes of management.

Because these comment letters are now publicly available, shareholders may question related areas of the company's financial statements.

Shareholder Questions

Restatements

— If the company restated prior years' financial statements, how was the problem discovered? Is the company certain that the full extent of the problem has been identified? What steps have been taken to ensure that this problem does not occur again?

— Why were there significant adjustments to the reported earnings of the company during a particular period or quarter? Are these adjustments indicative of weak management controls? How is management planning to correct the problems?

Complex accounting standards

— What controls does the company have over complex accounting transactions?

— Has the company reevaluated its method for valuing share-based payments? Are effective systems of internal control in place over accounting for share-based payments?

— How will the adoption of FASB Statement 123(R) affect the company's earnings?

— How will the company be affected by the FASB's project on pension and postretirement benefits?

— Is the company using the "shortcut" method of accounting for hedges? How sure is management that the company is meeting all the criteria for the use of this method? How does the company determine that its hedges are highly effective (from both a business risk management and a financial accounting perspective)?

— What procedures and controls does the company have over the use of derivatives and hedging? Has the audit committee reviewed these procedures and controls in the past two years?

Uncertain tax positions

— What is the company's accounting policy for uncertain tax positions? How will the FASB's proposal affect the financial statements?

— Is the IRS or any other taxing authority currently examining any of the company's tax returns? Have any changes been proposed? What is the likely outcome of these challenges? What is the company doing to minimize income taxes?

Other matters

— What factors does management use to assess the performance of its operating segments? Who is the chief operating decision maker referred to in the company's discussion of its operating segments?

— Were there any changes in senior-level personnel in the company's accounting function? What were the reasons for the changes?

Management's Plans and Strategies

Hedge fund activism, soaring stock buybacks, and new boardroom technology committees may signal a need to balance compliance with strategy.

The demands of the current legal and regulatory environment have taken up much of management's time in recent years and forced boards to concentrate on their monitoring function. So it's not surprising to see the emergence of a counter-force that pushes the pendulum in the other direction, forcing management and boards to spend more time on plans and strategies. Evidence of this swing can be found in hedge fund activism, soaring stock buybacks, and emerging technology committees.

Hedge Fund Activism

Hedge funds have become very aggressive in pushing companies for change. Basically, these funds are pools of money created and owned by pension funds and other institutions as well as wealthy investors.

These funds target companies whose stock is believed to be undervalued, then pressure management for changes that can boost the value of their holdings in the company.

Characteristics of companies that may be targeted by hedge funds include companies that are seen as not doing a good job on cost control. For example, some funds may regard executive pay as excessive and indicative of poor cost control. Hedge funds may also target companies with excess cash or real estate that is not increasing in value as fast as the funds think it should. A typical goal is to persuade these companies to use their cash and take more risk, for example by increasing capital expenditures or investing more in research and development.

By taking large stakes in companies, hedge fund activists can pressure management to take drastic actions, such as splitting up the company and selling off pieces of it to free up cash for investment or for return to shareholders.

Battles to break up companies may begin in proxy season and continue year round.

Because hedge fund tactics can be hostile in nature, they may be onerous to management and boards who must prepare time-consuming and costly legal, financial and operational responses. They can be equally troublesome to shareholders who may believe the goals of the hedge funds are inconsistent with theirs. This is especially true if the hedge fund's holdings are believed to be of short duration and involve complex transactions, such as short-selling and borrowed shares, that can give them voting power without economic risk.

Where the holdings are longer term, the tactics used by hedge funds may produce faster results than the shareholder resolutions voted on at annual shareholders meetings because they may begin during proxy season and then continue throughout the year. Smaller public companies tend to be less able to withstand these year round battles. Opponents of these tactics have criticized hedge funds for being for short-sighted and forcing companies to sacrifice long-term growth for short-term returns.

Stock Buybacks

While it is difficult to gauge the full impact on hedge fund activism, studies confirm that a key financial trend of the past few years has been the accumulation of cash by many companies.

Data compiled by Standard & Poor's shows these financial trends:

- Corporations in the S&P 500 have five or six times as much cash as they had ten years ago.
- The ratios of cash to stock market value and cash as a percentage of long-term debt are at unusually high levels.
- Stock buybacks as a use of excess cash are at an all-time high. The amount of money spent on stock buybacks by the S&P 500 has almost doubled over the past year.

The trend toward increased stock buybacks as a use of excess cash has pros and cons for shareholders. The pros are that it can increase earnings per share, an important metric of corporate performance. The cons are that it may indicate the company has no higher return project in which to invest the money, e.g., new products or new factories.

In addition, complexities in financial reporting can arise, if the company is simultaneously issuing stock options to employees. In such cases, the buybacks may offset the additional shares issued. However, com-

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panies may choose to disclose the buybacks more prominently than the options. In effect, some critics say, a significant portion of the buybacks may be viewed as "backdoor compensation" for employees.

The boom in stock buybacks may also raise the question of why the company didn't choose to pay out the money in dividends instead.

Technology Committees

A small but growing number of boards are setting up technology committees, a trend that bridges their monitoring role with their role of providing strategic business advice.

The Corporate Library, a corporate governance watchdog, reports that dozens of publicly traded companies now have some sort of board-level technology committee that is separate from the audit, investment, and compensation committees.

Basically, the technology committee's responsibility is to understand and evaluate the money the company is spending on information technology. As a result, the committee's activities may include probing the business outcomes from investment decisions and ensuring objectives are set and results measured.

One objective may be to ensure effective internal controls; another may be to improve profitability. Hence, the committee is called upon to balance monitoring and strategic activities and to oversee management's balance of short and long term goals.

Shareholder Questions

Stock buybacks, dividends, investments, and other uses of cash

— If the company has excess cash reserves, does it plan to buy back corporate stock or increase dividends?
— Does the company have an investment committee charged with making recommendations for employing excess working capital? What policies are in place to guide these investment decisions?
— What is the expected level of investment in research and development (R&D) in the next few years? Has the company benchmarked its R&D spending against competitors?

Prospects for growth and expansion

— What are the major strategic and operating problems facing the company now and in the next five years? How does management plan to address these issues?
— Have any new competitors entered the company's markets? How has the new competition affected the company's strategic planning? How did the company react to additional competition?
— What new products will be introduced this year and next year? Are competitors considering similar strategies?
— What is the company's share of the (product name) market? What is being done to increase its share?
— Does the company take steps to elicit feedback from customers on the level and extent of customer satisfaction?
— Are research and development capabilities or other intangibles critical to the company's competitive strategy? If so, which ones are critical and what steps is the company taking to protect or enhance these intangibles?
— Has the company formulated a plan to protect against the unauthorized use of trade secrets, know-how, and other information by former key employees?
— Does the company have alternate suppliers for key commodities, such as electricity and natural gas, that are essential to the company's processes?

Workforce and management succession

— What is the status of labor relations? Do any of the current labor contracts link wages to productivity increases? What issues will the company and union likely seek to negotiate when the current contracts expire?
— How much did the company spend to recruit and train personnel? How are these costs monitored, and how is cost effectiveness assessed?
— Who is next in line to succeed the CEO, Chairman, and CFO when they retire or otherwise leave the company? What is the likelihood of an external search?

Technological and financial innovation

— Has the company delayed any investments in technology due to Sarbanes-Oxley requirements?
— Is the company making the best use of its computer system? Could any accounting operations, presently performed manually, be computerized? Could the costs of its information systems be reduced?
— Is management up to date on information technology changes and does it regularly evaluate the possibility of implementation of new technologies where warranted?

Business Ethics and Corporate Social Responsibilities

Corporate ethics, contributions, labor standards, clean energy policies, and health issues are matters of interest to shareholders.

Business ethics and corporate social responsibilities are critical to the reputation and success of companies that operate on the public radar screen. Increasingly, companies are being called upon to report to their owners on their policies, practices, and progress on a wide range of non-financial areas including ethics, clean energy and healthy living, adherence to labor standards, and contributions – both political and charitable.

Clean Energy

Oil prices are soaring. Insurance companies are asking about the extent of a company's exposure to climate change. Countries in many parts of the world are prepared to impose fines or restrictions on companies that don't address concerns over global warming. So companies already have plenty of incentives to address environmental concerns. Coming on top of all these trends, the demands of today's new breed of socially responsible investors simply add to the pressures.

The requests from shareholders typically vary with the nature of the industry in which a company operates and the extent of its non-U.S. operations. Carmakers may be asked to reduce auto emissions. Oil companies may be asked for more progress in low-carbon emissions and reports on greenhouse gas emissions, a suspected cause of global warming.

Companies with non-U.S. operations may be asked what preparations they have made to comply with the Kyoto Protocol, an agreement among 38 industrial nations that went into effect in February 2005. The Kyoto Protocol requires reductions in emissions of greenhouse gases to a level below the 1990 level by 2012.

Responses to questions about clean energy may involve the company's business travel polices. Possible steps include the following:

- Asking hotels and car rental agencies about their clean energy policies and requesting that travel management companies obtain reports on the environmental impact of air travel plans.
- Negotiating deals with preferred suppliers based partly on such factors as whether the suppliers produce the lowest possible greenhouse gas emissions, use solar energy, and have efficient waste management.
- Introducing "carbon neutral" policies for business travel. For example, if it is possible to quantify, any adverse environmental impact of business trips might be offset by making a contribution to an organization investing in projects that reduce the impact of emissions.
- Encouraging teleconferencing and rail travel as substitutes for air or auto travel.

Other responses will likely involve changes to the company's products, services, or processes. For example, carmakers may point to hybrid cars, computer-makers may cite power-saving sleep modes, and financial institutions might reward borrowers buying energy-efficient homes. A particularly innovative solution announced by a copier manufacturer includes plans to develop a rewritable paper printer that can erase existing photocopied images, enabling customers to cut back on paper consumption.

Healthy Living

Some issues of current interest to shareholders would appear to fall within the category of healthy living. These issues include the following:

- Retail food establishments are being asked to label all genetically modified food products.
- Drug and chemical makers are being asked to adopt policies that reduce the use of animal testing and to report on the feasibility of amending their animal care standards so they also apply to contract and outside laboratories.
- Drug makers are being asked to report on the effects of prescription drug reimportation from Canada into the U.S.

Contributions

Shareholder activists have been pushing companies to issue reports on their political contributions and to disclose the guidelines for those contributions. A key area of concern is that boards may not be reviewing "soft money" political contributions made indirectly through trade associations or independent political committees. In response, share-

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holder resolutions are calling for a system of accountability. Some ask that reports be presented to the audit committee, or other relevant oversight committee, and posted on the company's Web site.

One reason for these requests is a fear that executives may use company assets for objectives not necessarily shared by the board or the shareholders. Another reason is a concern that these contributions can cause risks for shareholders if the company winds up in the middle of a political scandal. A handful of companies have already agreed to these requests during the 2006 proxy season.

Some companies are also receiving requests for more disclosures related to charitable contributions. These requests stem from concerns about corporate support for sensitive causes that may conflict with religious or family values.

Family Values

Questions may also arise from members of religious groups and others who espouse family values. Groups, such as "One Million Moms," have been active during the past year in dissuading companies from supporting laws, events and media coverage not consistent with their values.

Labor Standards

Pension funds continue to ask companies to adopt the labor standards of the International Labor Organization and United Nations and to agree to outside monitoring. But these standards are not uniformly enforced around the world, and rights groups disagree on the best way to monitor or inspect workplaces.

A private-sector alternative is now underway. This initiative was organized by a group of companies including Nike and Gap along with six leading anti-sweatshop groups. Known as the Joint Initiative on Corporate Accountability &Workers' Rights, the group has set as its objective the development of a single set of labor standards with a common factory inspection system. The expected completion date is the end of 2007.

Ethics and CSR Reports

In an attempt to take the initiative and communicate the many aspects of their "corporate citizenship" prior to shareholder meetings, a growing number of large companies are issuing "Corporate Social Responsibility" (CSR) reports. A study by the Social Investment Research Analyst Network (SIRAN) in 2005 found that 40% of the S&P 100 issue CSR reports.

For example, Wal-Mart, the largest U.S. private employer, released a diversity report in 2005 that includes detailed statistics on the gender and ethnic breakdown of its employees. The company's CEO has indicated the report will be released on a regular basis.

The exact contents of CSR reports vary by company. Some are quire comprehensive. For example, General Electric's 96-page 2005 "Citizenship Report" addresses a wide range of topics, including governance, compliance, and public policy.

One of the most distinctive features of GE's report is a section describing the company's code of conduct or integrity guide titled *The Spirit & the Letter*. This section describes a companywide policy of compliance beyond what the rules require. Among other things, the report provides the results of GE's internal process for reporting integrity concerns without fear of retaliation, with statistics showing the incidence of the concerns reported through the company's "ombudsperson process." The reported concerns range from fair employment practices and supplier relationships to intellectual property and insider trading.

While not all companies have the resources to provide reports comparable to GE's, shareholders of smaller companies may ask questions about comparable aspects of other companies' policies and procedures.

Shareholder Questions

Business ethics

- Has the company adopted a code of ethics for its principal executive and senior financial officers? Were any waivers granted?
- Has the company established a written policy on corporate conduct regarding possible conflicts of interest and illegal acts, to guide key personnel in their business activities?
- Do the company's codes of ethics and corporate conduct cover its entire global operations?
- Has the company considered how the actions of "outsiders" such as agents, suppliers, and distributors reflect upon their ethics and compliance programs?
- Is there a system in place that allows employees to raise ethics and compliance issues without fear of retribution?
- Is there a process in place that allows management and the board of directors to address issues that arise from any level of the organization?
- Is the company's reward system (promotions, bonuses, and salary increases) aligned with the objectives of the ethics and compliance programs?
- Does the company regularly and systematically scrutinize the causes of compliance failures and respond appropriately?
- Does the company issue (or is it planning to issue) a Corporate Social Responsibility (CSR) report? If not, why not?

Clean energy and healthy living

- What is the extent of the company's exposure to global warming or climate changes?
- What is the company doing to reduce greenhouse emissions or otherwise prevent or mitigate climate control risks?
- Is the company investing in (or does it plan to invest in) renewable energy sources?
- Is the company insured for claims related to environmental matters? Have the company's environmental policies affected its insurance rates or coverage?
- What are the company's procedures for addressing the risks associated with hazardous chemicals, and how is toxic waste disposed? Are any of the company's products considered carcinogenic? How are employees protected from dangerous chemicals? How does the company's safety record compare to similar companies?
- Does the company recycle its waste and manufacturing byproducts? If not, why not?
- Do the company's manufacturing operations comply with environmental laws? Is the company subject to any U.S. or international actions related to its environmental responsibilities?
- Do the company's products or services contribute to any unhealthy conditions, such as obesity?
- Are the company's products labeled appropriately to warn users of any risks?
- Were any of the company's products recalled for safety violations? Did the company's reaction appropriately balance the interests of customers with those of shareholders? Are there any legal issues related to the recall?

Labor standards

- Does the company comply with labor standards set by the International Labor Organization and United Nations?
- Is the company outsourcing jobs to offshore locations? If so, what are the risks? Has the company disclosed the locations of all facilities located outside the U.S.?
- How often are non-U.S. locations inspected for working conditions and compliance with labor standards?
- How much of the company's revenues come from parts of the world with high HIV/AIDS prevalence rates?
- Has the company implemented mandatory drug testing in the workplace? If not, why not? How have the employees or their unions reacted to testing by the company?
- Does the company maintain a smoke-free environment for its employees? If not, why not?
- What are the company's equal opportunity policies? Has the company publicly disclosed data reported to the Equal Employment Opportunity Commission (EEOC) or otherwise reported publicly on the diversity of its workforce?
- What policies and procedures does the company have to prevent workplace harassment??
- Does the company support any causes, events or media coverage that might be seen as inconsistent with family values?
- What is the company doing to improve the quality of public education in the communities in which it operates?

Contributions

- Has the company publicly disclosed the details of its charitable and political donations? If not, how much was donated, and what criteria are used to determine which organizations receive donations?
- Does the company have a political action committee (PAC) and, if so, what is its purpose, how is it administered, and how are funds raised? What candidates does the PAC support?

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Shareholder Communications and Investor Relations

Technological innovation could revolutionize shareholder communications and provide faster, better and cheaper information to shareholders and analysts.

Proxy season 2006 arrives on the eve on an SEC-led technological revolution. Just over the horizon, companies may enter a new world of shareholder communications with faster and better information for investors and analysts at lower costs. For now, though, companies will need to contend with low-tech solutions to formidable challenges, including how to analyze their investors base and hold the line on earnings guidance and fair disclosure practices.

Investor Bases

Companies and shareholders may want to know a few facts about the investor base, especially at a time when shareholder activism is reported to be at its highest since the 1980s era of corporate raiders and “Barbarians at the Gate.”

As activist shareholders are exerting pressure on management to the point of attempting to oust directors who side with management, the types of useful information about a company’s investor base might include facts about the types of investors who own stock in the company, the voting history of these investors, and the issues likely to be foremost on the minds of any dissident investors.

The identities and email addresses of dissident shareholders would be especially helpful since management might want to reach out and communicate directly with these and other investors on the issues. But gaining access to shareholder contact information is easier said than done in the U.S. Approximately 80% of shares are held in “street name,” meaning, they are registered in the name of the broker or dealers through whom the shares were bought.

Currently, the primary means by which companies communicate with shareholders is by printing bulky proxy statements and annual reports, then sending them through low-tech delivery systems. This is costly and slow. If a broker holds the shares in street name, the company’s printed materials must pass through the broker.

E-proxies could open the door for companies to communicate more directly with investors.

The SEC’s December 2005 proposed rule on “Internet Availability of Proxy Materials” could bring big changes to this system. The SEC has proposed that companies be allowed to post their proxy materials on their Web sites instead of printing and mailing the documents. These e-proxies could open the way for companies to obtain direct access to email addresses and other information about their shareholders and investor mix.

Some aspects of the SEC’s proposal are controversial. Activists and dissident shareholders feel they should be free to communicate directly with shareholders too. Supporters worry the complexities may lead the SEC to delay the rules or phase them in over time. Until electronic proxies are sufficiently operational, companies will still need to conduct costly market studies to analyze their investor bases, and they will need to communicate with shareholders indirectly.

Earnings Guidance

Companies communicate more directly with securities analysts through conference calls and briefings that help the analysts gauge the company’s value and forecast its future results.

In prior years, this interaction has typically involved the providing of earnings guidance. But studies show companies continue to cut back on earnings guidance provided to investor and analysts. A survey of its members by the National Investor Relations Institute in March 2006 found:

- The percentage of publicly traded companies giving out guidance dropped to 66% from 71% in the prior year.
- Among those companies that continue to provide guidance, the nature of the guidance has changed. The percentage giving quarterly guidance fell to 52% from 61% a year ago, while the percentage giving annual guidance increased from 61% a year ago to 82% today.

Regardless of their policies on earnings guidance, however, many companies provide analysts with other

information. Increasingly, the trend is to provide a wide range or "dashboard" of financial and non-financial measures.

The reasons for these trends are not entirely clear, though many blame it on today's legal and regulatory environment, charging that companies may be afraid of the adverse consequences of releasing information that could be construed as misleading. Others blame the chilling effects of the SEC's Regulation Fair Disclosure (FD).

Fair Disclosure

The SEC's Regulation FD is a well-intentioned effort to level the playing field between analysts who get information directly from companies and shareholders who get their information indirectly.

Basically, the rule prohibits selective disclosure of material non-public information to one investor or selected groups of investors. But critics of the rule say it has chilled spontaneous communications, and the rule has proven difficult to enforce. In September 2005, a federal judge ruled against the SEC and dismissed a lawsuit based on Regulation FD, saying the SEC was applying the rule in an "overly aggressive manner." (SEC *v. Siebel Systems*)

XBRL and Interactive Data

Faced with practical difficulties but unwilling to give up on its objective of fair disclosure, the SEC has taken an innovative approach that centers around technology and interactive data. This technology may empower companies to provide more types of information electronically, thereby easing the calculations done by analysts and achieving the goal of fair disclosure by making the information available to individual investors at the same time.

The centerpiece of this technology is XBRL (eXtensible Business Reporting Language), a way of tagging data that helps third parties, (such as banks, investors, analysts, credit companies) make comparisons of companies with competitors, across industry lines, and within market groups or indices.

Some companies are already using XBRL. To expand the number of participating companies, the SEC is offering incentives to companies to participate in voluntary reporting programs. These incentives include faster reviews of annual reports and registration statements.

Companies have other incentives to use XBRL. Some companies whose results are already reported in XBRL by third parties (such as companies in the Russell 3000 whose XBRL reports were made available through a leading EDGAR service provider) have said they would prefer to control the tagging to ensure there are no mistakes.

In addition, experts say XBRL may benefit smaller companies (micro-cap companies) by helping them to attract an analyst following. Coverage by analysts has been equated with lower volatility in stock prices and higher market capitalizations.

Because XBRL technology is not widely understood, shareholders may have questions about its cost, availability, risks and benefits.

Shareholder Questions

Investor base

— What is the total number of shareholders? Who are the principal shareholders?
— How many institutional investors own shares in the company, and what percentage of the total shares outstanding are owned by institutions? What are management's reasons for rejecting any suggestions made by these institutions?
— How much of the firm's stock is owned by hedge funds? What do these investors want? What are management's reasons for rejecting any suggestions made by these funds?
— How will the company be affected by the SEC's proposed rules on internet availability of proxy materials?
— What procedures has the company implemented to prevent trading of its stock based on inside information?

Communications with shareholders

— Who in management is responsible for shareholder communications and responding to shareholder questions?
— Does the company provide a process for investors to communicate with directors? If not, why not?
— Has the company designated at least one independent director whom shareholders can contact?

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Shareholder Questions (continued)

- Has the board developed and disclosed communications policies covering all forms of communications, including in-person meetings, telephone calls, e-mail and other written communications?
- Does the board take an active role in ensuring shareholder communications efforts and policies are up to date and effective?
- Does the company maintain a Web site that provides helpful information to investors?
- Has the company considered participating in the SEC's XBRL program? What are the pros and cons?
- Were any proposals submitted to management for inclusion in the proxy statement that management decided not to include? Why were certain issues omitted from the proxy? Why doesn't the company permit confidential voting by shareholders with an outside party tabulating the results?
- Can a summary of significant matters discussed at the annual meeting be distributed to shareholders?
- What is the company doing to improve its annual report and make it more understandable to shareholders?

Communications with analysts

- Has the company established and disclosed corporate policies for responding to requests for access to knowledgeable company officials and other qualified persons, including securities analysts and investors?
- Does the company maintain frequent contact with analysts who follow the company? Which analysts are recommending the company's stock?
- If the company does not have an analyst following, how does this affect the stock price? Does the company expect to be able to attract an analyst following in the future?
- How has the company's practice regarding earnings guidance changed in recent years? Why? Will the company continue to provide earnings guidance to analysts?
- Does the company publish earnings forecasts? If so, do the forecasts include the components of earnings (revenues, expenses, gains, losses, margins, earnings per share, etc.)? What factors are used to derive these forecasts?
- Does management expect any increase in the volatility of the company's stock price due to changes in earnings guidance?
- Does management agree with analysts' expectations for earnings in the next quarter and for 2006 earnings? If there are disagreements, how are they communicated to analysts and investors?
- If it is necessary to revise earnings forecasts, how will this information be communicated to the public?
- How does the company ensure that changes in earnings forecasts are communicated in a manner that prevents insiders from benefiting from advance warnings?

Trends and competitive analysis

- If the company does not provide earnings guidance, what information does it provide to analysts?
- Has the company provided information about trends and competitive analysis?
- Why did the market price of the company's stock fluctuate so dramatically compared with shares of its competitors?
- Has the company provided five-year growth rate projections?
- What are management's plans for maximizing shareholder value in 2006 and beyond?
- What actions are being taken to ensure shareholder value is maximized on a long-term basis?
- Which business segment is growing the fastest and why? What are the anticipated sales and earnings changes for each of the company's business segments?
- How is the economy affecting the company's expectations for sales, earnings, and dividends for next year? What growth rates are expected for the company this year and next? What are the most significant factors that impact these performance expectations? Which factors are beyond the company's control?
- How do the company's operating results and financial ratios compare with those of its competitors?
- How do the company's product quality and productivity goals compare to those of its competitors?
- How does the company's business cycle affect the current quarter's performance?
- How does the current quarter's performance contribute to the company's long-term strategy?
- How do first quarter earnings compare to the earnings that were projected for the period? What estimates are the most significant in formulating realistic earnings expectations?

Table 1

Shareholder Questions on Timeless Topics

This table provides a listing of shareholder questions that are timeless in the sense that they may be asked from year to year.

Audits and Audit Committees

Internal controls

— What is the tone from the top regarding a strong and effective internal control system?
— Is the company experiencing any significant resource constraints in complying with Section 404?
— What are the implications of an adverse opinion on the effectiveness of internal controls or on the late filing of the company's Form 10-K?
— Has the company developed a system to monitor compliance with the SEC's Regulation Fair Disclosure on the dissemination of material, nonpublic information?
— How have internal controls kept pace with the company's growth and increased complexity?
— Does the company have an internal audit department? How large is the department? What are its responsibilities? Are members of that department independent of all accounting functions? To whom does it report?
— Do auditors, either internal or external, visit all of the company's locations at least annually?
— How does the company protect its internal systems and network from "hackers"?
— Did the auditors identify any material weaknesses in internal control? Have corrective actions been taken?
— What procedures are in place to prevent overrides in the internal control system? Has management discovered any overrides in the system? What procedures were implemented to prevent this from occurring? Did the company report these violations to the auditors and audit committee?
— What did the external auditors conclude about the adequacy of the company's computer control activities?
— Are there adequate physical safeguards for computer software and hardware? Is there a disaster recovery plan in place?
— Has the company taken measures to prevent the infiltration of computer viruses or other intrusions?

Fraud prevention and detection

— Does management adequately evaluate the risk of fraud throughout the organization? What is management doing to deter and detect fraud?
— Does the company have a documented procedure for following up on all reported issues through the company's hotline?
— How were reported issues resolved during the year?
— Has the company appointed a chief compliance officer?
— What is the audit committee's responsibility for fraud awareness and detection?
— How does the audit committee address the risk of management override of controls?

The audit committee

— How did/will the Sarbanes-Oxley Act, along with the rules adopted by the SEC and the various stock exchanges, improve the workings of the audit committee?
— What criteria are used to select the members of the audit committee? What are their qualifications and backgrounds?
— Does the company's present audit committee include at least one financial expert under the new SEC definition? Who is (are) the financial expert(s) on the audit committee? What are the qualifications of the financial expert(s)?
— How are the qualifications of the "non-financial expert" members of the audit committee assessed?
— Does the audit committee receive continuing education?
— How does the company monitor that the audit committee members are independent?
— How are audit committee members compensated?
— Does the company indemnify audit committee members in the event litigation arises that relates to possible conflicts of interest or negligence of the board? Is D&O insurance provided? Is the insurance adequate and available next year?
— Have any audit committee members or their immediate families been employed by the company within the last 5 years?

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Table 1

Shareholder Questions on Timeless Topics (continued)

Audits and Audit Committees (continued)

The audit committee's responsibilities

- Did the audit committee implement a whistleblower policy? Did the audit committee develop a complaint system to receive, retain, and treat complaints? Who monitors complaints in the company?
- Does management review the company's annual report with the audit committee? Did the audit committee question any of the conclusions reached by management? Do the external auditors discuss the quality of the accounting principles used by the company with the committee?
- Were the company's interim financial statements and press releases reviewed by the external auditors and discussed with the audit committee before they were issued?
- Does the audit committee have access to adequate resources to perform its duties properly? What is its budget for the coming year?
- Do the external or internal auditors have direct access to the audit committee? How many times did the external or internal auditors meet with the audit committee during the past fiscal year? Does the work of the internal auditors complement the work of the external auditors?
- Did the audit committee evaluate the work performed by the external auditors?
- Did the audit committee evaluate internal controls by reviewing the external auditors' and internal auditors' recommendations for improving internal control and monitoring management's implementation? Did the audit committee express any significant concerns regarding the company's internal control system?
- Is the audit committee aware of any possible illegal acts or conflicts of interest? If so, what is being done about them?
- Do management and the external auditors discuss the accounting treatment for large and unusual or significant year-end transactions with the audit committee?
- Does management discuss with the audit committee the company's critical accounting policies? Has the audit committee required any changes to the company's critical accounting policies based on those discussions? Has the audit committee engaged consultants to assist them in obtaining an understanding of the critical accounting issues?
- What issues did the audit committee discuss with the external auditors last year? How were these issues resolved?
- Does the audit committee review the internal auditors' reports? How are the recommendations made by internal auditors evaluated for possible action?

The audit committee's oversight of tax risks

- Does the audit committee oversee tax risks? Does the company's tax director regularly brief the audit committee on areas of tax risk and exposure?
- Does the company compare its tax rate with those of its competitors? Does the audit committee agree with the company's philosophy with regard to tax minimization and tax planning?
- Does the audit committee feel the company has adequate tax expertise and resources to manage its tax risks?
- Does the audit committee challenge the strength and completeness of internal controls over tax accounting and tax risk mitigation? Does it review the estimates and judgments involved in accounting for income taxes?
- Does the audit committee determine that executive compensation plans are tax-compliant?

Relationship with auditors

- How were the external auditors selected?
- When will the lead partner and concurring partner rotate off the company's audit? Do the replacements have adequate expertise? Has the audit committee reviewed their credentials?
- Do the external auditors provide non-audit services to the company? What is the nature of these services, and how much has been incurred in fees? Does the company plan on using the external auditors for non-audit services in the future?
- What criteria does the audit committee use in deciding whether to pre-approve nonaudit services?
- Were there any disagreements with the external auditors that arose during the year or were issues discussed with them that relate to management's integrity? If so, what were they? Were they brought to the attention of the board of directors or audit committee, and how were they resolved?

Table 1

Shareholder Questions on Timeless Topics (continued)

Audits and Audit Committees (continued)

Relationship with auditors (continued)

— What percentage of the consolidated audit hours do firms other than the principal external auditors provide?
— Why were the external auditors changed last year? What criteria were used to select the current auditors?
— Did the external auditors report on the adequacy of the company's internal control? If not, why not?
— What were the results of the external auditors' latest peer review?
— Did the external auditors provide advice and assistance in reviewing the financial statements of merger candidates prior to their acquisition during the year?
— Did the external auditors review the "pro forma" disclosures in the company's recent press releases?
— Does the company use outside accountants other than the external auditors for non-audit services? If so, what did these services involve? Were the external auditors informed if other outside accountants were consulted on issues that might affect the company's accounting or financial reporting?
— Why do firms other than the principal auditing firm audit certain subsidiaries, divisions, or segments? Does the principal auditor take responsibility for the audit work performed by others?
— How significant are the fees paid by the company to the external auditors in relation to the total revenues of the external auditor?

Other

— Has the company paid its PCAOB support fees?
— Which transactions were executed with related parties? What was the business purpose of the transactions? Were the terms of the transactions at amounts approximating arm's-length or fair value? Who are the related parties? Why were related parties used? Are these transactions benefiting any specific shareholders, creditors, or others? Is the board of directors required to approve these transactions? Did it?

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Table 2

Shareholder Questions on Timeless Topics

This table provides a listing of shareholder questions that are timeless in the sense that they may be asked from year to year.

Management's Plans and Strategies

Mergers and acquisitions

— Does the company plan to initiate or expect to receive any merger proposals?
— How would the company determine if a proposed merger would benefit the shareholders?
— Can shareholders rely on fairness opinions provided by investment bankers?
— Why has or hasn't the company employed anti-takeover measures, and how does this impact shareholder value?
— Has the compensation committee approved any significant change-in-control payments?
— Did the company delay any planned M&A transactions due to Sarbanes-Oxley requirements?
— Did anyone acquire a significant interest in the company recently? If so, what are their intentions? What is management's reaction to this? Is shareholder approval required for business acquisitions and divestitures?
— Does the company anticipate Company Z, which now owns a significant percentage of the company's stock, will increase or decrease its holdings? What impact will this have on share prices? How many seats on the board of directors does Company Z have?
— Why did the company acquire Subsidiary X or invest in Joint Venture Y? How successful was the acquisition? What is the fair value of the company's investment? What long-term rates of return does management believe are sustainable for these new investments? What measures did management take to ensure that the amounts paid for these investments were fair?
— Why did the company divest itself of Subsidiary X? What was the fair value of the assets? Did the company receive at least the fair value? How was fair value determined?

Dividends, investments, and other uses of cash

— What are management's plans for the proceeds from the recent issuance of its stock or debt, or from the sale of Subsidiary X, patents, trademarks, or tangible assets such as plant, equipment, or real estate?
— If the company has reduced dividends, why were dividend reductions made without first reducing other cash outlays, including executive compensation?
— How does the company's dividend policy compare to the industry? Has the company considered declaring a stock split or stock dividend? Would a stock split or stock dividend have a positive effect on long-term shareholder value?
— Has the company considered adopting a dividend reinvestment program?
— How are investment returns on potential new capital projects assessed?
— What was the nature of R&D costs for each of the last three years? Does the company spend more or less (as a percentage of sales) on R&D than its competitors? What new products were introduced in 2005 as a result of R&D efforts? Were any R&D projects abandoned? If so, what were their costs?
— What is the amount of the company's capital budget for next year and the following year? Are cash flows from operations sufficient for these needs? If not, how will these requirements be financed?

Response to changes in tax laws

— Does the company expect to create jobs as a result of the American Jobs Creation Act (AJCA)?
— Has the company revised its nonqualified deferred compensation plans to comply with the AJCA?
— Does the company have a board-approved plan to claim the tax beak on repatriated earnings under the AJCA?
— Are there any other new or contemplated tax law changes that had an effect on the company in 2005 or will have an effect in future periods? (Consider Federal, foreign, and state laws.) Will the company consider increasing or decreasing asset allocations as a result of tax law changes in foreign or domestic jurisdictions?
— How does management assess whether tax-planning strategies are effective in managing its income tax obligations domestically and on a worldwide basis?

Table 2

Shareholder Questions on Timeless Topics (continued)

Management's Plans and Strategies (continued)

Response to changes in economic or political environment

— What effect does the state of the economy or political environment in the U.S. or in other countries have on the company? Does the company expect any benefits or difficulties as a consequence of these conditions?

— How did domestic and international economies affect 2005 operations? What would be the impact on 2006 profits if additional foreign economies experience difficulties this year?

— Who are the company's major foreign competitors? Does the company have plans to address increased foreign competition? What are they?

— If U.S. interest or inflation rates rise, how will that affect the company? How will increases in the price of oil and other commodities affect the company?

— How have the company's financial results been affected by the war in Iraq? What steps has the company taken to protect its personnel and facilities from terrorism and war?

— What is the likelihood that a foreign government will nationalize the company's operations?

— Which foreign countries, if any, restrict or prohibit the repatriation of earnings or assets?

— How does the company plan to take advantage of the bankruptcy of Competitor Y? Why did the competitor fail, and what measures is the company taking to ensure that a similar fate is not in store for itself?

— Does the company rely heavily on imports or exports, or compete with foreign companies? If so, how will the changing value of the dollar or the current political environment affect the company's competitive position? What measures are being taken to reduce the possibility of loss from foreign currency exchange rate changes?

— Is the company susceptible to exposures arising from market risks and concentrations (e. g., major customers, products, geographical)? How does the company address these risks?

Prospects for growth and expansion

— What are the major strategic and operating problems facing the company now and in the next five years? How does management plan to address these issues?

— Have any new competitors entered the company's markets? How has the new competition affected the company's strategic planning? How did the company react to additional competition?

— How have new products been received in the marketplace? What are the expected market shares and profit contributions of each new product? What are the expected lead times and product life cycles?

— Are any of the company's products subject to government regulation? Does the company have any significant new products awaiting government approval? What is the expected approval date?

— What percentage of the company's sales is from government contracts? Are any of these contracts subject to renegotiation? When do such contracts expire?

— Are the benefits or useful lives of any products questionable due to competition, patent challenges or expiration or other factors?

— Has the company attempted to raise the prices of its products or services recently? Was this successful? If not, then why not? What percentage of the sales increase or decrease was the result of price increases or decreases? Of volume increases or decreases?

— How does the company maintain the quality of its products? What quality assurance procedures are currently in use? Are additional quality assurance procedures being considered?

— Does the company have any significant sales or purchase commitments for commodities that are vital to sustain critical operations? Are financial derivative contracts, such as futures contracts, used to ensure a steady supply or constant price for these items?

— Why does the company rely exclusively on a particular customer or supplier, or on a relatively small number of customers or suppliers? Could this relationship adversely affect shareholder value?

— Does the company hedge price risks on commodities that are critical to the business?

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Table 2

Shareholder Questions on Timeless Topics (continued)

Management's Plans and Strategies (continued)

Prospects for growth and expansion (continued)

— Are any of the company's significant customers experiencing financial difficulties? Are any of the company's significant customers under investigation by the SEC or any other law enforcement agency? What are management's plans to minimize any adverse impact that might result if these customers become insolvent? Have the company's credit policies been reviewed to reflect changes in the economic environment?

— How much did the company spend on advertising in 2005? What are advertising expenditures expected to be in 2006? What factors are considered in determining if advertising is effective?

Workforce and management succession

— What is the status of labor relations? Do any of the current labor contracts link wages to productivity increases? What issues will the company and union likely seek to negotiate when the current contracts expire?

— Are members of management required to retire at a certain age? If so, what age? Does the retirement policy preclude those individuals from entering into consulting arrangements with the company? Has the company considered implementing, amending, or eliminating retirement policies?

— Why did specific managers leave the company? What termination benefits are being paid? Are they precluded from establishing relationships with competitors of the company?

Technological and financial innovation

— How is the company making use of technology in its manufacturing operations? How is management addressing employee, union, and community concerns about jobs being eliminated through plant automation?

— Does the company sell its products or services over the Internet? If not, does the company plan to establish Internet commerce?

— What precautions are being taken to ensure that information transmitted through the Internet does not fall into the wrong hands or become compromised? Does the company have a privacy policy regarding customer and employee information?

— What new financial products are being offered to customers? Are these products being marketed by competitors? Is the company a participant in any of these transactions? If yes, what is the maximum exposure to the company if the financial products fail to perform as intended?

Cost-cutting and restructuring programs

— What steps has the company taken to streamline or restructure its operations? Are additional steps under consideration? If yes, when will this be announced, and what is the expected impact on earnings in the current year and future years? Has the company notified employees who might be affected?

— Does the company plan to offer early retirement or other termination incentives to employees to reduce costs and overhead expenses?

— What is the company doing to control employee benefit costs?

— What amount was incurred by the company for health care costs for its workforce last year and last quarter? What steps are being taken to control these costs? Has the company considered self-insurance to better manage these costs? Why does the company provide or not provide health insurance for retirees? Does the company believe it would incur significant cost increases if legislation were passed that regulated managed-care providers?

— What plans are in place to assist displaced workers? What is the labor union's position on this issue?

— Has the company outsourced any of its data processing, manufacturing, or other operations? If not, has this been considered and how were the risks of this action assessed? How much of its operations did the company move to offshore locations? Were the overall economic consequences considered?

— Is there any idle production capacity? If so, what actions are being considered to eliminate it?

— How is the company controlling its energy costs in the current operating environment?

Table 2

Shareholder Questions on Timeless Topics (continued)

Management's Plans and Strategies (continued)

Risk management

- What risk management techniques are used to evaluate the adequacy and cost effectiveness of insured risks? What is the limit of the company's product liability and catastrophic loss coverage?
- Does the company self-insure any risks? How sensitive are earnings to changes in assumptions about self-insurance?
- Does the company have a risk assessment committee?
- What guidance has the board of directors given management in developing a risk management system?
- What oversight role does the board of directors have to ensure the integrity of the company's risk management system?
- Has the company purchased or sold any finite-risk insurance products?
- Is the company considering any changes in its insurance practices?
- Has the company had difficulty obtaining terrorist insurance? Or any other type of insurance?
- Is there a proper separation of duties between those who create financial risks and those who manage and control risks?
- Does the company use enterprise risk management?
- What is the company's attitude towards financial risks?
- Were there any significant foreign currency exchange gains or losses in 2005 and in interim 2006 operations? What is the company doing to minimize the impact of changes in foreign currency rates? Does the company hedge its foreign currency exposures?
- What types of financial instruments and derivatives does the company use?
- How are the company's financial instruments and derivatives valued?
- Does the board of directors understand the implications of the company's financial instruments, specifically derivatives (e.g., options, futures, forwards, caps, collars, interest rate swaps)?
- Does the company have written guidelines and policies on the use of financial instruments and derivative instruments? Who formulated those policies? Did the board of directors approve those policies?
- Is there a limit system in place (i.e., a system that sets the maximum amount of loss the company would tolerate before liquidating a position)?
- What are the major risks from the company's use of financial instruments or derivatives?
- Do management and the board of directors monitor the company's financial instruments and derivatives exposures?
- Does the company plan to change its use of derivatives, co-cos, synthetic leases or other financial instruments?
- How does the company monitor the retirement plans' investment performance? Do the external auditors audit the plans' financial statements? Who sets the investment policy for the plans' assets?
- What additional costs were incurred as a result of the events of September 11, 2001? Has the company had to implement additional security measures?

Capital structure

- What is the company's current price-earnings ratio? Why is it so high or low compared to competitors? In light of this, why has or hasn't the company issued additional common stock to meet its business expansion plans?
- How does the company's debt-to-equity ratio compare to the ratios of its major competitors? How does the company use debt to maximize shareholder returns? How are the risks associated with the current debt load assessed?
- What interest rates would the company pay if it were to issue additional long-term debt in today's market? How do these interest rates compare to those that the company is currently paying on its debt obligations?
- What portion of the company's long-term debt bears interest at floating rates? What portion is denominated in foreign currencies? Has the company considered measures to reduce the risk of fluctuations in interest rates or foreign currency exchange rates?
- Will the company be able to satisfy its short-term cash requirements without obtaining additional financing through the issuance of new debt or equity securities? How did the company make that assessment? Can capital be raised quickly if needed? What contingency plans are in place if it is necessary for the company to react to sudden changes in the economy? Can the company increase its short-term borrowing arrangements with banks, if necessary, and how is the company's current relationship with its banks?

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Table 2

Shareholder Questions on Timeless Topics (continued)

Management's Plans and Strategies (continued)

Capital structure (continued)

— Has the company considered any revisions to common stock voting rights? Has the company considered issuing other classes of common stock with rights and privileges different from those accorded to the company's common stock? What would be the benefits of such a class of stock?

— How do FASB Statement 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*, and the FASB's project on liabilities and equity affect the company's capital structure? (See our Financial Reporting newsletter, *FASB Statement No. 150 Brings Big Changes* (July 2003), at http://www.bdo.com for a summary of possible changes.)

— Has the company violated (or approached violating) any loan covenants? If so, what costs were incurred to obtain waivers or to restructure these debts? Are additional violations expected in the near term?

— Has the company considered adopting or rescinding an employee stock purchase plan?

Sources of financing

— How has the outlook for the stock market and bond market affected the company's plans for a public offering of its stock or debt? What industry or company factors are relevant in creating a favorable environment for raising additional equity or issuing debt? Does the company plan to refinance any of its existing debt?

— Would the company consider obtaining additional financing from a private placement of its common stock or debt to institutional investors? Why or why not? Would institutional investors receive more favorable terms in comparison to the terms that might be negotiated with other third parties?

— Is the company considering any divestitures? If the company is considering any M&A transactions in order to reduce risks attributable to its current operating concentrations, how would they be financed?

— Would the company pay a market premium if it were able to purchase large blocks of shares from institutional investors? How would this affect the share price?

— Why does the company issue options, warrants, and convertible securities if such securities have the potential to dilute the interests of current shareholders? How do these actions increase shareholder value?

Liquidity and debt

— What is the company's bond rating? Why was the company's credit rating changed, and what impact will this have on future borrowings? Did the company anticipate this change? What steps are planned to improve the ratings?

— Is it possible that the company will restructure its debt or file for bankruptcy protection? What effect would this have on existing shareholders, creditors, employees, and the communities in which the company operates?

— Have transactions such as asset sales and sale-leasebacks been considered to satisfy liquidity needs?

— How will liquidity of the company be affected by restrictions placed on Subsidiary X, which prevent it from paying dividends to the parent company?

— Will any pending litigation affect the company's liquidity needs? How does management assess the potential economic impact of litigation in deciding what course of action it will take?

— Why did the company incur a deemed dividend or unusual financing charge as a result of beneficial conversion terms on convertible preferred stock or debt? Why did the company offer below-market conversion terms?

Table 3

Shareholder Questions on Timeless Topics

This table provides a listing of shareholder questions that are timeless in the sense that they may be asked from year to year.

Understanding Financial Statements

Quality of financial reporting

— Is the company clearly and accurately disclosing the compensation, benefits, and perquisites of executives?

— Has the company selected appropriate accounting policies? Why does management use a particular accounting method (e.g., revenue recognition, amortization method, and cost deferral) in light of different policies used by the company's competitors? Has the company consistently and properly applied the appropriate accounting policies? Are the company's overall accounting policies aggressive or conservative?

— Did the company consult with the SEC regarding any accounting matters during the past year?

— How does management assess the significant operating, market, and credit risks that are discussed in the annual report?

— Why does the company file financial reports with the SEC on Form 10-KSB (which requires only a balance sheet for the current year and income statements, statements of comprehensive income, and cash flow statements for the most recent two years) rather than on Form 10-K (which requires balance sheets for the last two years and income statements, statements of comprehensive income, and cash flow statements for the last three years)?

— Were any accounting policies or estimates changed this year? To what extent are estimates by management part of the financial reporting process? Which estimates are considered critical? How does management determine when and if a change in estimate is appropriate?

— Why did the company change its method of accounting for ___? Why is this method better than the former one? Did the external auditors provide the company with a preferabilty letter?

— What is the quality of the company's earnings (e.g., unusual or non-recurring sources of income that are not separately disclosed)?

Recent accounting changes

— Has the company determined the impact of the Medicare Drug Subsidy?

— What is the funded status of the company's pension plans? What does the company intend to do about any over-funded or underfunded plans? Has management considered any changes to those pension plans?

— What is the assumed long-term rate of return on pension plan assets for accounting purposes? How did management (and the audit committee and the auditors) conclude that the assumed long-term rate of return is a realistic long-term expectation?

— Does the company have any variable interest entities (VIEs) or special purpose entities (SPEs), or other "off-balance sheet financing" arrangements? What transactions does the company enter with VIEs or SPEs and why? Are the SPEs consolidated? Are there any related parties involved with any such entities or arrangements? How did the company determine that it did not need to consolidate any such special purpose entity?

— Is the company using special purpose entities for its real estate assets?

— Did the company provide any financial guarantees? What impact did the issuance of FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*, have on the company?

— What were the major costs included in the company's restructuring charge? When is the plan expected to be completed? What are the estimated efficiencies and savings expected in future periods? Have the estimated efficiencies and savings from the restructuring been compared to actual results? What was the impact on the company's restructuring accrual due to the issuance of FASB Statement 146, *Accounting for Costs Associated with Exit or Disposal Activities*? What impact will Statement 146 have on restructurings in the future?

— What incentives are used to ensure each operating segment is maximizing shareholder returns? Did the company change any of its operating segments as a result of the goodwill impairment test required by FASB Statement 142, *Goodwill and Other Intangible Assets*? How did that change affect the goodwill impairment loss?

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Table 3

Shareholder Questions on Timeless Topics (continued)

Understanding Financial Statements (continued)

Recent accounting changes (continued)

— What is goodwill, and why did the company report a goodwill impairment loss? How does the company assess the recoverability or value of goodwill? How did the company determine its reporting unit(s) for purposes of the good-will impairment test? Did the company hire valuation specialists? How likely is it that a large goodwill impairment loss may occur during the next few years?

Uncertain tax positions

— If the company has had the benefit of utilizing net operating losses, when does the company expect to begin paying taxes or incur a "normalized" tax provision?
— What strategies does the company use to minimize corporate income taxes? Are any of these strategies subject to challenge by the tax authorities? Are the effects of potential income tax disallowances reflected in the financial statements?
— Has the company entered into aggressive tax avoidance or deferral techniques? Who approved those transactions? Would the company do them again?
— Have tax authorities challenged the company's pricing on intercompany transfers between foreign and domestic jurisdictions? What is the likely outcome of that challenge?
— Did the company pay any significant Federal, state, or local tax, or foreign penalties recently? What measures are being taken by management to reduce or eliminate non-deductible interest and tax penalties?
— Does the company have an internal tax function? If not, which outside firms are used to provide tax advice? Are any members of these firms also directors of the company?

Financial condition

— What do the captions "unearned compensation," "accumulated foreign currency translation adjustment," "unrealized gain or loss on marketable equity securities," "comprehensive income," "accumulated other comprehensive income," and "minimum pension obligation" represent?
— Why did the company write down the value of assets this year or last year? What effect will the write-down have on future reported profits?
— Does the company have receivables denominated in foreign currencies? Are there any collection problems?
— Has the company invested in the debt obligations of any nation that is currently experiencing economic difficulties?
— Has credit been extended to Asian or South American companies? Are the loans denominated in U.S. dollars, and are any loans in default?
— Did the company enter into any securities repurchase agreements with financial institutions or other counterparties during the year? Were the agreements with well-known and reputable companies? Did the company obtain or surrender control of the underlying collateral that secures the value or reduces the risk of these transactions? How is compliance with management policies for these transactions monitored?
— What does the caption "deferred tax asset" represent? Why are income tax benefits being deferred? If a valuation allowance was used to reduce reported deferred tax assets, what assumptions were used in determining the allowance? Are those assumptions consistent with the company's and analysts' expectations about future earnings?
— Why does the caption "redeemable preferred stock" appear outside of the stockholders' equity section of the company's balance sheet? How much preferred stock was redeemed at the option of investors during last year and the last quarter? What factors influence investors' decisions about whether they redeem their preferred stock? Has manage-ment taken actions to encourage or discourage redemptions? How would the company fund the redemption of the preferred stock? What factors does management consider in determining whether it chooses to "call" or redeem cer-tain outstanding securities? Why is the dividend rate or interest rate different for these securities versus those secu-rities that are not redeemable at the company's option?
— How did the company determine the fair value of financial instruments that are disclosed in the annual report? If values were not disclosed, why was the company unable to determine their fair value?
— Since the fair value of certain financial instruments is so much higher or lower than their cost, why isn't the difference recorded in the financial statements?

Table 3

Shareholder Questions on Timeless Topics (continued)

Understanding Financial Statements (continued)

Results of operations

— What is the significance of the caption appearing in the financial statements titled “comprehensive income”? What components are included in other comprehensive income, and why are these items excluded in determining net income?
— Why do operating profits as a percentage of sales differ among business and geographic segments? What is management doing to promote increased margins in Segment X?
— How was the company’s financial performance affected by the changing value of the dollar in relation to a specific foreign currency?
— Does management anticipate incurring losses from concentrations of credit risk that are discussed in the annual report? What is management doing to reduce credit risk concentrations? Will these actions impact sales and earnings?

Trends

— Does the company believe its current financial condition is stronger or weaker when compared to one year ago? What factors does management use to assess the company’s financial condition? Are management incentives based on financial condition, cash flows, results of operations, or a combination of these factors? If so, why?
— Does the company hold any real estate or other assets that have increased in value but are not reported at fair value in the financial statements? If yes, which assets have increased in value and by how much? Does the company’s stock price reflect this fact?
— What are the factors that cause differences between the company’s reported earnings and its cash flow from operations? In managing the business, does management rely more on reported earnings or cash flow? What are the most important economic trends that management relies upon in managing the day-to-day business of the company?
— Did sales and earnings meet management expectations in 2005? How are expectations benchmarked?

Other matters

— Does the company intend to use XBRL reporting?
— Why did the company delay its SEC filing and/or earnings release for its 2005 fiscal year-end?
— Why doesn’t the company release earnings earlier?
— Will the company be able meet the accelerated filing dates for SEC filings?
— Why does the price of the company’s stock decrease or increase so much in response to relatively small changes between actual and expected earnings? Does this volatility relate to the price-earnings multiple of the company’s stock?

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Corporate Governance Update and Shareholder Questions: 2006

A *Financial Reporting letter*

For More Information

If you would like further information or to discuss the implications of the matters discussed in this Financial Reporting letter, please contact the BDO Seidman engagement partner serving you or one of the following partners: Ben Neuhausen or Wayne Kolins.

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