



# Financial Reporting

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## Shareholder Questions – 2004

*This Financial Reporting letter was prepared and distributed by BDO Seidman, LLP to help our clients anticipate and respond to questions that may be asked in 2004.*

The 2004 proxy season marks the start of a new era of corporate governance. Major drivers of the changes include increased interaction among investors, more open shareholder communications processes, significant changes in accounting standards, and a host of new regulations, including SEC and stock exchange listing rules.

Already, technology and specialists in corporate governance are pushing the boundaries of shareholder communications through conference calls, webcasts and online transcripts. Together these resources are opening up the dialogue between management and large institutional investors for the benefit of all shareholders.

At the same time, regulatory changes are helping to accelerate the trend toward increased investor scrutiny. Topping the list of shareholder concerns this year is executive compensation, fueled in part by new stock exchange listing rules that require shareholder approval of stock option plans and repricings.

Another area of top concern is directors' qualifications. This topic reflects new SEC rules requiring disclosures about directors' selection criteria and attendance at annual meetings, along with an explanation of the means by which shareholders can communicate directly with directors. These rules will help ensure the continuation of increased scrutiny, expanded interaction and sharpened questions throughout 2004 and for many years to come.

# Management's Plans and Strategies

Today, as in the past, shareholders are concerned about their company's ability to adapt to the changing political and economic environment.

A key issue at 2004 annual meetings is likely to be the company's ability to create jobs. Although economic growth is accelerating in the U.S. and many parts of the world, employment figures have lagged behind. These statistics raise doubts in some minds about the consequences of outsourcing jobs to developing countries.

International events also raise concerns about the company's ability to adapt. The security of employees and customers is likely to be a continuing concern following renewed terrorist attacks in some parts of the world. In addition, European trade sanctions against some American products may raise questions in the industries affected. Investors will

want to know how management is adapting its plans and strategies.

Any corporate response that involves cost-cutting or cost-containment measures is likely to cause concern. Questions may arise this year about the impacts of these programs, including the effects on workers of any restructuring plans. Investors may also ask about the longer-term impact on shareholder value of any cutbacks in investments, such as research and development.

Other questions may relate to the company's ability to adapt to business trends. Arguably the most important business trend in recent years is the increased dependency of companies and their customers on intangibles, including knowledge, cultural values, and technological advantages. Companies should be prepared to identify

intangibles that are sources of competitive advantages or disadvantages and describe the steps they are taking to protect or enhance these intangibles.

Another key business trend relates to privacy concerns. These matters have grown more important in recent years as cases of identity theft have become more prevalent and widely publicized. Companies should be prepared for questions about the security of their computer systems, including their ability to protect the privacy of customer and employee records.

**“Strategies that succeed are organic. They wrap themselves around problems, challenges and opportunities, make progress and move on.”**

**Robert H. Waterman, Jr.**

*The Frontiers of Excellence, 1994*

## Shareholder Questions

- 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?

### Growth and expansion

- Does the company expect to create jobs this year or in the near future?
- Where does the company plan to expand its business? How does management expect its operations in these locations will be affected by possible political and economic changes?
- How will U.S. trade agreements with China affect the company's operations?
- What new products will be introduced this year and next year? What are the expected market shares and profit contributions of each new product? What are the expected lead times and product life cycles? Are competitors considering similar strategies?
- What is the expected level of research and development (R&D) spending in the next few years? Has the company benchmarked its R&D spending against competitors? What new products and services will result from these efforts and when? What are the expected returns on investment for these new products, and how long will it take to recover R&D costs incurred? Are there any plans to alter the company's R&D efforts (e.g., switch from in-house to partnerships/alliances or vice versa)? What are the commitments under these arrangements?
- Are research and development capabilities or other intangibles critical to the company's competitive strategy? If so, which ones and what steps is the company taking to protect or enhance these intangibles?

### **Economic and political fallout**

- What effect does the state of the economy or political environment in other countries have on the company? Does the company expect any benefits or difficulties to arise as a consequence of these conditions? What steps has the company taken to protect its personnel and facilities from terrorism and war?
- If foreign economies experience sudden declines, how would the company react to the possible flood of cheap imports from foreign competitors? If those countries boycott American made goods and services, what would be the impact on the company?
- How will European trade sanctions affect the company?
- How is the company affected by the weak U.S. dollar and/or low U.S. interest rates?
- 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?
- Will the company's financial results be affected by the war in Iraq?
- Who are the company's major foreign competitors? Does the company have plans to address increased foreign competition? What are they? What effect will the war in Iraq have on your foreign competition?
- 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?

### **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 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?

### **Technological and financial innovation**

- 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?
- 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?
- 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?
- 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?

### **Mergers, acquisitions, and management succession**

- 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? Why has or hasn't the company employed anti-takeover measures, and how does this impact shareholder value? Has there been any change in the company's philosophy toward future acquisitions since the issuance of FASB Statements 141, *Business Combinations*, and 142, *Goodwill and Other Intangible Assets*?
- 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?

# Liquidity and Capital Resources

Questions may arise about the company's willingness and ability to adapt its financial strategies and structures to changes in accounting rules, tax laws, and ever more complex financial instruments. These questions are likely to focus on the impact of changes or trends on the company's liquidity and capital resources, an area involving complex issues that are not easily answered.

The media have speculated that changes in financing could result from plans underway at the Financial Accounting Standards Board (FASB) to reconsider instruments with characteristics of both liabilities and equity, particularly if the plans lead FASB to require classification of more types of instruments as liabilities.

Sophisticated financing tools, including contingent convertible bonds (co-cos) and synthetic leases, have also gotten their share of media attention, as both have come under increased scrutiny by regulators and accounting standard-setters as well as shareholders.

Similarly, derivatives and the possibility of hidden debt triggers have continued to receive a considerable amount of media attention. Because derivatives figured prominently in the accounting restatements at Fannie Mae and Freddie Mac, they may continue to concern investors despite new SEC rules that require enhanced disclosures.

Among other things, the SEC rules, which were released in December 2003, require disclosures about derivatives linked to the com-

pany's stock and the potential impact of known or reasonably likely changes in credit ratings or rating outlooks. These disclosures are required in the management's discussion and analysis section of annual reports.

On the investment side, questions may arise about any dealings with mutual funds that were (or may have been) involved in illegal selling or trading practices.

**“A company can always make it through thick and thin providing the thick isn't their executives and the thin isn't their capital.”**

**Anonymous Epigram**

Heard on the Street

## Shareholder Questions

- Does the company plan to change its use of derivatives, co-cos, synthetic leases or other financial instruments?
- Has the company considered adopting or rescinding an employee stock purchase plan?
- How does FASB Statement 150 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?

## Ratio analysis and risk assessments

- 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?

### 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 mergers, acquisitions, or divestitures in order to reduce risks attributable to its current operating concentrations? What are management's acquisition or divestiture plans? How would they be financed?
- Does the company expect to buy back any of its own common stock? 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?

### Investment plans and policies

- 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?
- How are investment returns on potential new capital projects assessed? What factors are weighed in deciding what course of action should be taken in the event a particular project fails to meet expectations?
- 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?
- Does the company invest in junk bonds or highly leveraged companies? What criteria are used to assess the credit risk and reward for these investments? How does the company avoid possible conflicts of interest whenever members of management have business or investment relationships with these companies?
- Are there long-lived assets (e.g., goodwill, intangibles, fixed assets) whose values could be suspect given unfavorable operating results, adverse regulatory matters or other negative developments? What impact did FASB Statements 142 and 144 have on the company's earnings?
- 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?
- Have the company or its employee benefit plans invested in any mutual funds? If so, how will the company be affected by changes in that industry?

### 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?

### Dividend policies

- 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?

# The Legislative and Regulatory Environment

The legislation with the broadest impact on public companies again this year is likely to be the Sarbanes-Oxley Act of 2002. The Act and related rule-making initiatives addressed a lack of confidence in businesses and the U.S. capital markets that was described as “America’s greatest economic need.”

The result of this legislation was a host of new rules constituting a heavy regulatory burden that can be costly for public corporations, both large and small. Shareholders in larger companies may probe the exact cost of compliance. Shareholders in smaller companies may wonder if management intends to stay the course and continue on as a public company.

In some cases, shareholders may question the possibility of the company going private through buyouts by management or investment groups. In others, their questions may probe the possibility of the company deregistering with the SEC or being dropped from a stock exchange or electronic quotation system, with the result that the company would then be subject to less rigorous oversight, rules and reporting requirements.

Investors may be especially worried about these courses of actions if the company has two classes of securities, with the voting power concentrated in one class.

Other legislative and regulatory issues of broad consequence this year include legislation aimed at

protecting pension and healthcare benefits for workers and retirees despite corporate cost-cutting. Questions in this area may focus on the impact of the Medicare Drug Subsidy and other recently proposed or enacted laws, as well as court decisions and changes in the tax and accounting rules for cash balance plans and other defined benefit pension plans.

**“At this moment, America’s greatest economic need is higher ethical standards—standards enforced by strict laws and upheld by responsible business leaders.”**

**President George W. Bush**

Referring to a series of high-profile accounting scandals.  
Speech, July 2002

## Shareholder Questions

- How much it is costing the company to comply with the Sarbanes-Oxley Act of 2002?
- In light of the demanding provisions of the Sarbanes-Oxley Act, would the company consider plans to deregister or go private? How would this action affect current shareholders and creditors? If the company plans to go private, how would current shareholders be assured that they will receive a fair price?

### SEC rules and securities laws

- 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 matter X, and what is management doing to resolve the issues?
- Has the company had any difficulty maintaining its stock exchange listing?
- 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?

### Tax laws

- Are there any new or contemplated tax law changes that had an effect on the company in 2003 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?
- 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?
- How does management assess whether tax-planning strategies are effective in managing its income tax obligations domestically and on a worldwide basis?

- Has recent tax legislation regarding dividend income altered the company's dividend policy?
- 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 internal legal and tax functions? If not, which outside firms are used to provide legal and tax advice? Are any members of these firms also directors of the company?

### **Patents and intellectual property**

- Why has it taken so long for the company's patent applications to be approved or for FDA or other approvals to be obtained? What is the likely impact on sales and earnings if they are or are not obtained? When does the patent expire on product X?
- How does the company protect the integrity of existing patents, technology, and intellectual property overseas?

### **Other laws and regulations**

- What percentage of the company's sales is from government contracts? Are any of these contracts subject to renegotiation? When do such contracts expire?
- Is the company in compliance with immigration rules and regulations? How is compliance with laws and regulations monitored?
- Does the company have overseas operations? How do foreign wages and benefits compare to those for the company's U.S. workers? What are the working conditions of employees or those of its suppliers (including children) who are based in developing nations? How does the company monitor its compliance with local and international standards or laws? Do company employees inspect the facilities of foreign suppliers?
- 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? If the exam resulted in the discovery of deficiencies, how is management planning to address the problems identified?
- 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?
- What effects do cheap imports have on the company? What is the company's position on import quotas? Is the U.S. Customs Service investigating the company's importing and exporting practices? If so, what is the status of the investigation?
- 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?
- 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 company complied with the provisions of the Health Insurance Portability and Accountability Act?
- Did the Patriot Act have any impact on the operations of the company? Did the company have to eliminate shipping any explosive type materials as a result of the Patriot Act? Did the company need to implement additional security or monitoring procedures?
- How will the company's retirement and benefit plans be affected by the Medicare Drug Subsidy and other recently proposed or enacted laws, court decisions and changes in the tax and accounting rules for cash balance plans and other defined benefit pension plans?

# The Outlook for Future Earnings

Questions about the outlook for the company's future earnings are likely again this year, and the questions about the future may probe longer time horizons due to controversy over the practice of providing earnings guidance to security analysts.

Critics of earnings guidance say the practice creates unhealthy pressures to meet numerical targets, adding to the risk of earnings manipulation. Supporters maintain, "what gets measured gets managed," and some may fear an increase in the volatility of stock prices if guidance is halted.

In a spirit of compromise, management may be switching to (or at least considering) other types of guidance for analysts. An increasingly popular approach, according to a study in late 2003 by the National Investor Relations Insti-

tute, is to release a range of estimates or an earnings model, together with more "soft" information, both qualitative and quantitative, about trends, estimates, assumptions and industry-specific information to help analysts and investors draw their own conclusions.

The trend away from focusing on a single bottom line number each quarter is also driven in part by new SEC regulations. Under SEC rules that took effect in 2003, companies must furnish their earnings releases to the SEC. Some audit committees who review these releases may be wary that the inclusion of earnings guidance in these releases will expose them to increased liability.

These concerns are heightened by economic uncertainties that have made it harder for companies to predict earnings.

To prepare for meetings amidst these changes and evolving trends, companies should be prepared for questions about a broader continuum of information. In addition to asking about next quarter's earnings, investors may ask about measures such as market share and shareholder value that help explain trends and longer-term outlooks and put future earnings estimates in the proper perspective.

**"When you have mastered the numbers, you will in fact no longer be reading numbers, any more than you read words when reading books. You will be reading meanings."**

**Harold S. Geneen**  
Former CEO of ITT  
*Managing*

## Shareholder Questions

- What are management's plans for maximizing shareholder value in 2004 and beyond?

### Trends and competitive analysis

- What actions are being taken to ensure shareholder value is maximized on a long-term basis? What is the single most important factor in achieving long-term goals?
- 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 product quality and productivity goals compare to those of its competitors?
- How does the company use information technology to help achieve competitive advantages? Does the company have a chief technology officer responsible for recommending and implementing new technology? Approximately what costs were incurred last year and this year, and what costs does the company expect to incur next year?

### Earnings guidance and future projections

- Will the company continue to provide earnings guidance to analysts?
- How has the company's practice regarding earnings guidance changed in recent years? Why?
- Does management expect any increase in the volatility of the company's stock price due to changes in earnings guidance?

- Are any changes in accounting methods contemplated? Will the transition allow shareholders to obtain meaningful comparisons to earnings reported in prior years?
- Does the company publish earnings forecasts? What factors are used to derive these forecasts? Are these intentionally conservative?
- The safe harbor provisions of the Private Securities Litigation Reform Act encourage companies to make forward-looking information available to the public. Does the company take advantage of this safe harbor? What is the best estimate of sales and earnings for this year and next?
- 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?
- How does the current sales backlog compare with that experienced by the company in the prior year? Why has it changed? Is management able to determine the sales backlog of competitors? If yes, has this backlog increased or decreased relative to the company's experience? Why?

### **Fair disclosure**

- Does management agree with analysts' expectations for earnings in the next quarter and for 2004 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?

# Risk Management

The area of risk management has expanded in recent years and become more complicated as a result of threats ranging from derivatives to hackers and terrorist attacks. Companies should be prepared for questions about both the newer areas and the more traditional areas of risk management.

An evolving approach that has become more popular following enactment of the Sarbanes-Oxley Act is the use of “enterprise risk management” to assess and report a broader range of risks. Currently, there is considerable diversity in the terminology and methodology used by different companies. To help provide a more uniform level of quality, the Committee of Sponsoring Organizations of the Treadway Commission (COSO) released a draft framework in 2003 with the expectation of finalizing it in 2004.

Enterprise risk management (ERM) is seen as a way for management and audit committees to identify and measure a wide range of risks, including the risks that have resulted from the initiation of required certifications under the Sarbanes-Oxley Act and emergence of a tougher enforcement environment.

Another way for companies to help manage these risks is to appoint a chief compliance officer or a corporate responsibility officer whose position signals the company’s commitment to complying with both the letter and the spirit of the highest governance standards.

But neither ERM nor chief compliance officers provide a way for investors to measure the risks of ineffective corporate governance. To gain insights about the risks associated with a company’s system of corporate governance, shareholders

may look to any one of a number of firms that assess companies and rank them according to the strength or weakness of their governance.

Preliminary studies have shown a high level of correlation between high corporate governance ratings and increases in stock prices. However, subscriptions to these services may be too costly for masses of individual investors, and they may choose instead to ask about a company’s risks and ratings at its annual meetings.

“There are risks and costs to a program of action. But they are far less than the long-range risks and costs of comfortable inaction.”

**President John F. Kennedy**

Speech 1961

## Shareholder Questions

- Does the company use enterprise risk management?
- Has the company appointed a chief compliance officer?

### Risk management

- 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 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 those risks?

### Financial risks

- What is the company’s attitude towards financial risks?
- 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?
- What types of financial instruments and derivatives does the company use?
- How are the company’s financial instruments and derivatives valued?

- 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?

### **Other risks**

- 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?
- Does the company have alternate suppliers for key commodities, such as electricity and natural gas, that are essential to the company's processes? Does the company hedge price risks on the commodity?
- 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?
- 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?
- Will the current economic problems faced by foreign countries have an impact on the company's operations? Has the company considered reducing or increasing its investments in those countries? Have alternative sources of supply and investment been considered?
- How have political uncertainties in specific regions of the world affected the company's current operations and future earnings expectations? What is the likelihood that a foreign government will nationalize the company's operations? What effect would nationalization have on the company as a whole? What contingency plans does the company have to protect its foreign assets? Which foreign countries, if any, restrict or prohibit the repatriation of earnings or assets?

# Understanding the Financial Statements

Over the years, newly effective accounting standards have often triggered questions from shareholders about the financial statements and accompanying notes. Closer scrutiny by investors can be expected in 2004 because the annual meetings follow an unusual wave of restatements.

In some cases, the questions may probe difficult legal and accounting issues due to the complex nature of the changes in accounting standards that took effect in 2003. A prime example would be the new accounting rules that address special purpose entities (SPEs) of the type that imploded a major company into bankruptcy, resulting in serious and

widely publicized consequences for its investors.

Other major changes in accounting that affect financial reporting for 2003 relate to the accounting for financial instruments with characteristics of both liabilities and equity, costs associated with exit or disposal activities, and obligations resulting from guarantees, as well as disclosures by employers about pensions and other postretirement benefits.

In addition, the Financial Accounting Standards Board allowed companies to defer accounting for the effects of the Medicare Drug Subsidy pending issuance of a final accounting rule in 2004. Investors may want an update on the status of this matter at annual meetings.

Companies should also be prepared to answer general types of questions that probe management's view on the overall level of improvement in the quality of financial reporting or the appropriateness of their accounting policies and their commitment to abide by the spirit as well as the letter of the accounting standards.

**“Without financial reporting premised on sound, honest numbers, capital markets will collapse upon themselves, suffocate and die.”**

**Arthur Levitt, Jr.**

Former Chairman of the U.S. Securities and Exchange Commission  
Speech, 1999

## Shareholder Questions

- Has the overall quality of the company's financial reporting increased during the past year? (See our *Financial Reporting* newsletter, *Assessing the Quality of Financial Reporting in 2003* (March 2004), for a discussion of key questions raised by recent events and trends, along with techniques to help improve the quality of financial reporting. The newsletter is available at <http://www.bdo.com>.)
- 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?
- 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?

### Recent accounting standards

- Has the company been required to restate earnings?
- Did the company consult with the SEC regarding any accounting matters during the past year?
- 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 overfunded 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? Will FASB Interpretation No. 46R, *Consolidation of Variable Interest Entities*, require consolidation of those entities? If so, how will the company be affected by consolidating them?

- Did the company provide any financial guarantees? What impact did (will) 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? (See our *Financial Reporting* newsletter, *Year In Review – Significant 2002 Financial Reporting Developments* (February 2003), at <http://www.bdo.com> for a summary of Interpretation 45.)
- 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? What impact will Statement 146 have on restructurings in the future?
- 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? What incentives are used to ensure each segment is maximizing shareholder returns? Did the company change any of its operating segments as a result of the FASB Statement 142 goodwill impairment test? How did that change affect the goodwill impairment loss?
- 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 goodwill 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?

### 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 management 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 certain outstanding securities? Why is the dividend rate or interest rate different for these securities versus those securities 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?

### 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 did domestic and international economies affect 2003 operations? What would be the impact on 2004 profits if additional foreign economies experience difficulties this year?
- Were there any significant foreign currency exchange gains or losses in 2003 and in interim 2004 operations? What is the company doing to minimize the impact of changes in foreign currency rates? Does the company hedge its foreign currency exposures?
- How was the company’s financial performance affected by the changing value of the dollar in relation to a specific foreign currency?
- 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?
- 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?
- 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?

### Other matters

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

## Getting Beyond the Numbers

An important lesson learned from the recent rash of accounting scandals and restatements is that investors must make an effort to get beyond the numbers reported on the face of the statements to fully understand a company's financial condition and results of operations.

Several key sources of information found in SEC filings help investors get beyond the numbers and are likely to fuel shareholder questions. One source is the section devoted to contingencies and off-balance sheet obligations in management's discussion and analysis.

Another key source is the section on critical accounting estimates. Recent media accounts have cited a few of the many companies that use self-insurance techniques in which changes in estimates can result in big earnings swings.

The section of SEC filings on related party transactions is another key source of information and questions. Many companies report transactions with related parties, such as corporate officers, and some of these transactions involve significant dollar amounts. Questions from shareholders may probe whether the related parties have a conflict of interest in that they are acting in their own best interest rather than in the best interests of the shareholders.

Other questions may arise from assessments of the quality of earnings. Shareholders may ask about any one of many factors that can negatively affect the quality of earnings. Examples include income from noncash sources, use of estimates, or inclusion of nonrecurring items.

Some investors may have concerns about earnings releases or annual reports that present figures for items that are not in accordance with generally accepted accounting principles (GAAP). Examples include "pro forma" earnings or "net debt." Under the SEC's rules, companies that follow this practice must explain why they use pro forma numbers rather than GAAP numbers, and they must provide reconciliations to GAAP numbers.

*"[Creative accounting practices] gave rise to the quip, 'A balance sheet is very much like a bikini bathing suit. What it reveals is interesting, what it conceals is vital.'"*

**Abraham Briloff**

*Unaccountable Accounting*  
1972

### Shareholder Questions

- 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?
- What is the quality of the company's earnings (e.g., unusual or non-recurring sources of income that are not separately disclosed)?
- Why does the company use "pro forma" numbers? How has the SEC's Regulation G affected the company?

### 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?

### Management actions

- 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?

## Financial Reporting

- What is the company doing to control employee benefit costs?
- How is the company controlling its energy costs in the current operating environment?
- 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?
- Did sales and earnings meet management expectations in 2003? How are expectations benchmarked?
- What is the company's share of the (product name) market? What is being done to increase its share?
- 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 do the company's operating results and financial ratios compare with those of its competitors?

### Intangibles, risks and uncertainties

- Does the company self-insure any risks? How sensitive are earnings to changes in assumptions about self-insurance?
- How much did the company spend to recruit and train personnel? How are these costs monitored, and how is cost effectiveness 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 2003 as a result of R&D efforts? Were any R&D projects abandoned? If so, what were their costs?
- 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 2003? What are advertising expenditures expected to be in 2004? What factors are considered in determining if advertising is effective?
- Are the benefits or useful lives of any products questionable due to competition, patent challenges or expiration or other factors?
- What additional costs were incurred as a result of the events of September 11, 2001? Has the company had to implement additional security measures?
- 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? Does the company employ competent personnel who are knowledgeable in the area of income tax law? If not, which outside sources are used to advise the company on complicated tax issues?

### Other matters

- Why doesn't the company provide more information about its expected earnings?
- Why doesn't the company release earnings earlier? Why are SEC filings (Forms 10-K and 10-Q) filed on the last possible day or on an extended date?
- 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?

## Executive Compensation

A number of megatrends combined to bring executive compensation and stock options into the limelight this year and make it the Number One issue for the 2004 proxy season. Companies should be prepared for questions about each of five major factors that succeeded in casting a spotlight on executive pay.

First, there were perceptions of social inequities following the accounting scandals. Media reports contrasted the amounts of stock options granted to executives with the circumstances of lower-level workers searching for jobs in a poor economy. The contrast was between hungry workers and top-level executives who were likened to “fat cats.”

Second, there were investigations into tax shelters. These investigations showed stock options could be used as a way of minimizing income taxes for companies.

Third, there were perceptions that executive pay is not well correlated with business performance.

Fourth, the SEC approved rules of the New York and Nasdaq Stock Exchanges that require shareholder approval of equity-based executive compensation plans, including stock option plans. These rules also require approval for repricings and material plan changes.

Fifth is the shift away from employee stock options to restricted stock as a result of criticism of excessive options grants and expected changes in accounting rules.

Executive pay is a much broader topic than stock options, and none of the factors casting the spotlight on executive pay had anything to do with errors or omissions in the financial reporting of stock options. Still, the aftermath of the accounting scandals created a “perfect storm” for the Financial Accounting Standards Board to move forward with a

proposal to change the accounting for stock options for both executives and lower-level employees.

The storm could go beyond executive pay, as investors recognize the full impact of the SEC Staff Legal Bulletin that facilitated shareholder voting on plans for rank-and-file employees in cases where these broad-based plans could potentially result in material dilution to existing shareholders. The fallout from this change in the SEC’s position could leave chief executive officers less vulnerable to pointed questions about their own pay and more closely scrutinized for their actions with respect to lower-level employees’ pay.

**“Sure, I’m one of the fat cats. In fact, I’m the fattest cat [at GE], because I’m lucky enough to have this job.”**

**John E. Welch,**

CEO of General Electric,  
Answering shareholder questions  
at GE’s 1997 annual meeting

## Shareholder Questions

- Does the company plan to curb its use of employee stock options? If so, will it issue restricted stock instead?
- How is executive compensation determined? Does the company have a formal compensation committee charged with the responsibility of setting fair, equitable, and competitive compensation awards that allow the company to achieve its goals? Does the board of directors periodically review the performance of the compensation committee?

### Stock options

- Does the company plan to issue additional incentive 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?
- 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?
- How would the company’s policy regarding the issuance of employee stock options change if the company is required to expense those options in the future? What is the company’s position on the FASB’s project on stock-based compensation?
- What portion of outstanding options is underwater? Why did the company lower the exercise price of stock options granted to its employees in prior years in response to the current decrease in the market price of the company’s stock

price? If the market price of shares continues to fall, does the company expect to continue to reprice these incentive options? Does the company plan any other incentives for retention of executives and employees with underwater options?

### Other aspects of executive pay

- How does the company justify the huge differential between its highest-paid executive and lowest-paid worker?
- What steps has the company taken to ensure management pay is tied to performance?
- Why did (or didn't) the company adopt the fair value method of accounting provisions of FASB Statement No. 123, *Accounting for Stock-Based Compensation*, to account for employee stock options? If the company did adopt the fair value method of accounting under Statement 123, what effect did the issuance of FASB Statement 148, *Accounting for Stock-Based Compensation – Transition and Disclosure*, have on the company? How did management decide which transition method was the most appropriate for the company? What effect did the issuance of Statement 148 have on the company's financial statement disclosures relating to stock-based compensation? (See our *Financial Reporting* newsletter, *Year In Review – Significant 2002 Financial Reporting Developments* (February 2003), at <http://www.bdo.com> for a summary of Statement 148.)
- Has the company taken any actions to protect executives' pensions in the event of bankruptcy?
- Is compensation based on subjective factors, a specific formula, or other objective criteria? Are compensation awards effective in increasing shareholder value? Do all members of management own stock in the company?
- Why did Mr./Ms. X's compensation increase or decrease, given the prospects of the company?
- Why did Mr./Ms. X's compensation increase even though the company's stock has underperformed the market, industry, or peer-group index?
- 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?
- Is officers' compensation comparable to that of similar companies? Is there a ceiling on officers' compensation? What correlation is there between executive compensation and the market price of the company's stock?
- Does the company use outside executive compensation consultants?
- Is all of the executive compensation deductible for income tax purposes? If not, why not? Is the company making any changes to its compensation programs as a result?
- 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?
- What benefits are payable to officers in the event of termination? Have any significant termination benefits been paid in recent years?
- Will the current loans to officers and directors need to be repaid to be in compliance with the Sarbanes-Oxley Act?
- What steps has the company undertaken to comply with the accelerated reporting deadlines on insider transactions?
- What perks are available to management? Are company airplanes, automobiles, club memberships, apartments, or other facilities available to executives or retired executives for personal use? Is the company reimbursed for the fair value of the personal use? How does this enhance shareholder value?
- Did the company pay for financial planning, tax, or legal services rendered to executives or retired executives by its external auditors, attorneys, or others?
- Are management perks and other fringe benefits approved by the board or its compensation committee?
- Are officers' expense accounts under budgetary control? Who reviews officers' expense reports? What was the total amount of executive expense allowances this year? How does that compare to last year?
- 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?
- Why are there so many interlocking directorships between the company's officers and the independent directors on the board or executive compensation committee?

## Code of Conduct and Internal Controls

Corporate codes of conduct and evaluations of internal control are time-honored techniques that have been used for years by leading corporations. Building on these solid foundations, new rules and regulations have sought to strengthen corporate codes and controls by introducing additional requirements.

Under Exchange listing rules of the New York and Nasdaq Stock Exchanges that take effect in 2004, companies must have codes of conduct that address key areas and the codes must be available on the company's Web site.

The same codes are integrated with corporate compliance programs that have allowed corporations to receive reduced fines under

the federal sentencing guidelines.

The guidelines may be modified soon to provide more relief to companies with strict compliance programs. The U.S. Sentencing Commission has been developing a proposal that would expand the benefits to companies that have programs to discourage white-collar crimes, even if top executives are convicted of legal violations. The Commission expects to send its proposal to Congress in 2004.

As a further preventative measure against future accounting scandals, new SEC rules slated to take effect in 2004 will require companies to include in their annual reports a report of management's assessment of the company's inter-

nal control over financial reporting, and the company's auditor will be required to attest to management's assertion.

Companies should be prepared for questions about their codes of conduct and their preparedness for reporting on internal controls.

**“Just because you have a high-minded statement of principles or send a certain percentage of your profits to save the rain forests doesn't mean you have the internal controls to prevent ethics problems.”**

**Ed Petrie,**  
Executive Director,  
Ethics Officers Association, 1997

## Shareholder Questions

- Have there been any violations of the company's code of conduct or overrides of its system of internal control?

### Codes of conduct

- Has the company adopted a code of ethics for its principal executive and senior financial officers?
- 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? How is compliance monitored? Do the policies apply to foreign subsidiaries? If so, are operations in foreign countries that have conflicting business practices adversely affected?
- Is there a system in place that allows employees to report, on a confidential basis, suspected fraud, misuse of assets, or violations of company policies?

### Internal controls

- 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? What will it cost the company to include this report and have the external auditors report on the internal controls? (See our *Financial Reporting* newsletter, *Compliance with Section 404 of the Sarbanes-Oxley Act: A Company Perspective*, (April 2004) at <http://www.bdo.com>.)
- Has the company implemented the recommendations of the Treadway Commission or the related Committee of Sponsoring Organizations of the Treadway Commission report in assessing and documenting its internal controls (e.g., management's report on internal control, risk assessment programs, codes of conduct, and internal audit functions)? If not, what actions are being considered that would be responsive to such recommendations?
- What is the difference between *disclosure controls and procedures* under Section 302 of the Sarbanes-Oxley Act and internal controls? (See our *Financial Reporting* newsletter, *SEC Requires Officers to Certify Periodic Reports and Accelerates their Due Dates*, at <http://www.bdo.com> for additional information.)

## Financial Reporting

- Has the company established policies and procedures for disclosing internal accounting control deficiencies and frauds identified to the auditors and the audit committee?
- What is the tone from the top regarding a strong and effective internal control system?
- 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 external or internal auditors identify any material weaknesses in internal control or other reportable conditions? 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?
- Are computer control activities reviewed by external auditors? What was their evaluation as to the adequacy of such 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?

## Audits and Audit Committees

Recent changes in the way independent audits are overseen and regulated may trigger questions from shareholders in 2004.

Audits are now overseen by the Public Company Accounting Oversight Board (PCAOB), which is funded by fees billed to public companies and accounting firms that register with the Board. The PCAOB is responsible for establishing standards for audits of public companies, as well as for inspecting and disciplining registered accounting firms.

Under SEC rules released in 2003, auditors are required to maintain stricter standards of independence and abide by new rules involving audit partner rotations, cooling-off periods, fee disclosures and audit committee pre-approval for non-audit services. The rules also require auditors to report certain matters to audit committees, such as critical accounting policies and estimates, along with alternative treatments and disclosures for material items discussed with management.

Audit committees must also abide by a host of new rules. In

addition to assessing auditor independence, they must ensure ethical conduct throughout the company and guard against attempts to improperly influence auditors. Further, they must review financial reports and filings, oversee internal control reporting, comply with the SEC's rule to disclose whether there is at least one financial expert on the committee, and ensure that procedures are in place to allow employee whistle-blowers to communicate directly with them.

The Sarbanes-Oxley Act requires that the audit committee take direct responsibility for appointing, compensating, and overseeing the work of the external auditors. Part of this responsibility is to resolve disagreements between management and the external auditors. Many audit committees also oversee the work of internal auditors.

There are more requirements if the company is listed on an exchange, such as the Amex, Nasdaq or New York Stock Exchange (NYSE). In some areas, these rules go beyond the SEC's rules. For example, the NYSE rules require that

each audit committee member must be (or soon become) financially literate and also meet strict independence and competency requirements, while the Amex rules require certification of financial expertise on the audit committee.

In addition, an internal audit function is required for companies listed on the NYSE, and both Nasdaq and NYSE rules provide specific items that must be included in the audit committee's charter and require discussions with external auditors about such matters as earnings releases and risk assessments.

Shareholder questions may relate to any and all these responsibilities. They may also probe whether or not the audit committee is meeting often enough, has adequate resources to discharge its many responsibilities, and consists of qualified individuals.

**“Sycophants are easy to find. Plain-spoken honesty is not. Like other rare commodities, it is highly valued.”**

**Wayne Kolins**

National Director of Assurance  
BDO Seidman, LLP, 2004

## Shareholder Questions

### The audit committee and its functions

- How did/will the Sarbanes-Oxley Act and the rules adopted by the SEC and the various stock exchanges to improve the workings of audit committees affect the company's 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 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? Does the audit committee have a charter?
- 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?

## Financial Reporting

- Did the audit committee adopt pre-approval policies for audit and permitted non-audit services that comply with the new SEC rules? How does the audit committee monitor the nature and extent of non-audit services performed by the external auditors? Has the audit committee implemented safeguards to ensure that the external auditors perform no prohibited services and that all permitted services are performed pursuant to its pre-approval policies? What effect has all this had on the level of non-audit services provided by the company's auditor?
- Does the audit firm provide any tax services? Do any of the services involve tax shelters?
- 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? Does the company provide directors' and officers' liability insurance to members of the audit committee? Does it expect that such insurance is satisfactory and will coverage be available next year?
- Have any audit committee members or their immediate families been employed by the company within the last five years?
- 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?
- Is the audit committee overseeing the company's preparations for internal control reporting under Section 404 of the Sarbanes-Oxley Act?
- 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?
- How often did the audit committee meet last year? Does the audit committee review the nature and scope of audit procedures to be applied by the internal and 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?
- Are the company's attorneys and external auditors instructed to report any illegal acts to the audit committee on a timely basis?
- 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?

### Relationship with auditors

- How were the external auditors selected?
- What factors are considered in the evaluation of whether the external auditors are independent?
- 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? Do management and the audit committee believe the rendering of these non-audit

services is compatible with the external auditors' independence? Does the company plan on using the external auditors for non-audit services in the future? What criteria do management and the audit committee use in deciding whether to pre-approve such 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?
- Were there any proposed audit entries that the company did not record? If so, why not?
- 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 are certain subsidiaries, divisions, or segments audited by firms other than the principal auditing firm? 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?

### Corporate Governance: Responsibilities of Directors

Directors' qualifications, responsibilities and performance are coming under increased scrutiny this year at many companies. Key issues involve the separation of the offices of the chairman and CEO, as well as the board's independence, meeting schedules and attendance at meetings.

Companies should be prepared for questions on all these matters, as well as questions on whether the directors will be able to meet the new responsibilities established by new Exchange Listing rules approved by the SEC in 2003.

Both the New York Stock Exchange and the Nasdaq Exchange have adopted rules that strengthen the definition of an independent director. They also require that companies have a majority of independent directors and disclose the basis for

that determination in the proxy statement or annual report.

The Exchange Listing rules also add new requirements that non-management directors must meet without management present at regularly scheduled executive sessions, and that each listed company must have a nominating or corporate governance committee composed entirely of outside directors.

In addition, the NYSE rules require that companies make their corporate governance guidelines available on their Web sites. The Nasdaq rules require approval of all related-party transactions by the audit committee or another independent body of the board of directors.

These requirements may represent radical changes from past prac-

tice at some companies. Even bigger changes may be in store for 2005. The SEC has proposed that shareholders be allowed to nominate directors in certain circumstances to help ensure the election of directors whose interests are aligned with those of the shareholders.

**“Nobody gave a hoot about corporate governance 15 years ago because a large part of what a company did to grow also increased shareholder value.”**

**Professor John Pound**  
Harvard University's Kennedy  
School of Government,  
Quoted in *Fortune*,  
January 11, 1993

#### Shareholder Questions

- How does the company monitor the continued independence of board members?
- Does the board have a nominating or corporate governance committee composed entirely of outside directors?
- Do the directors receive training?
- How is the company ranked on corporate governance scorecards?

#### The board of directors and its activities

- Has the board developed corporate governance guidelines?
- Are executive sessions of nonmanagement directors held regularly?
- What were the major areas addressed at the board level this past year?
- Does the board ever disagree with management? Were there any instances where the board rejected a course of action proposed by management?
- Has the company established policies and procedures for responding to the discovery of illegal acts and for informing the SEC about illegal activities as required by the Private Securities Litigation Reform Act?
- 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?
- How often does the board meet? Where were the meetings held? How much are directors paid for attending the meetings? What perks do directors receive?
- 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 directors' and officers' liability insurance to members of the board?
- How many directors are women or minorities? What actions are being taken to ensure that more women and minorities are represented on the board?

- What factors are considered in the selection process for the chairman of the board? When does the term of the chairman expire? How are replacement candidates identified and evaluated? Is the company's nominating committee comprised of outside directors to avoid a conflict of interest? Has the board considered separating the roles of chairman of the board and chief executive officer?
- 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?
- What was the attendance record of each director at board meetings and board committee meetings last year? Why has Director A missed X meetings?
- Why aren't there more independent directors on the board?
- Why did Director B resign? Have any other directors resigned since the company's year-end?
- Why isn't Director C slated for re-election this year?
- Are all directors shareholders? Does the company encourage directors to own shares in the company?
- Did any directors buy or sell significant amounts of company stock during the year? If so, why? Given the outlook for the company's future, why did these directors sell or buy stock?
- 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?
- Do directors sign conflict of interests statements prior to their appointments to serve?
- Did independent directors review and sign the annual report filed with the SEC? Did any directors refuse to sign?
- Are any of the directors also board members of companies who either compete or do business with the company?
- 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?
- Are there any age limits imposed for serving as a director? If not, then why not?
- What are the compensation arrangements for directors?
- Do any directors provide consulting services to the company? What services are provided? What are the fees? Are these services compatible with their responsibilities? Should such services be prohibited in the future?
- Has consideration been given to cumulative voting for the election of directors? Has consideration been given to staggering the terms of directors?

### Investor Relations

Shareholder questions may expand beyond the boundaries of annual meetings and receive more attention during the year as a result of a new SEC rule that took effect in 2004.

In its cost-benefit analysis of the rule, the SEC said one of the primary benefits will be to enable shareholders to communicate with directors. As a secondary benefit, the SEC said the rule may also help investors better identify the degree to which companies are responsive to shareholder concerns.

The new rule doesn't go so far as to require companies to establish processes for shareholders to send communications to board members. But any company that doesn't have such a process in place is required to explain why not.

Another expected benefit is enhanced transparency of the operations of boards of directors. Toward this end, the rule requires disclosures about the company's

nominating committee and the criteria it uses to select directors. If a company doesn't have a nominating committee, it must explain how its directors are selected.

In releasing the new rule, the Commission explained it was designed to respond to concerns from investors that they lack sufficient input into decisions made by the boards of directors of the companies in which they invest.

The rule adds to other tools that have recently become available to help individual investors sharpen their questions and provide informed input into decisions. In addition to the disclosures mandated by the SEC, investors have gained wider access this year to independent third party Web sites that facilitate discussions of proxy issues.

Webcasts and Web sites featuring transcripts of questions and answers from conference calls with management have provided indi-

vidual investors with a greater awareness of issues raised by large institutional investors.

As a result of added disclosures and access, companies should be prepared for more questions this year about directors, their attendance records, and the process for appointing them, as well as questions about the issues raised by institutional investors prior to the meeting. As the questions morph into a year-round exercise, the new processes will create "real-time" challenges for directors to develop "plain-English" responses to complex issues involving business, accounting, audits and financial reporting.

**"George Orwell once blamed the demise of the English language on politics. It's quite possible he never read a prospectus."**

**Arthur Levitt, Jr.**

Former SEC Chairman, quoted in  
the *New York Times*, 1996

### Shareholder Questions

- Does the company provide a process for investors to communicate with directors? If not, why not?
- Who can shareholders contact to obtain current information about the company? Does the company maintain a Web site that provides helpful information to investors? Does the company have an investor relations function?
- Does the company maintain frequent contact with analysts who follow the company? Which analysts are recommending the company's stock? Do they have investments in the company? Have there been instances of unusual trading volume in the company's stock? What caused this?
- What is the total number of shareholders? Who are the principal shareholders?
- 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, to 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?
- 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?

- 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?
- What procedures has the company implemented to prevent trading of its stock based on inside information?
- Why did the market price of the company's stock fluctuate so dramatically compared with shares of its competitors?
- Can a summary of significant matters discussed at the annual meeting be distributed to shareholders?
- Why doesn't the company include the Form 10-K as part of the annual shareholders' report?
- Why doesn't the company send quarterly financial information to shareholders?

# Social and Environmental Responsibilities

Questions about social and environmental responsibilities typically vary by industry. A key issue for the industrial sectors this year involves climate control. Suspicions are mounting that companies may be mortgaging both their own future and that of society by actions taken or not taken today.

The issue of climate control gained widespread media attention in late 2003 when the Investor Network on Climate Risk met at the United Nations Headquarters in New York to announce an environmental call for action. These investors want companies to reduce emissions of greenhouse gases, which they believe contribute to global warming. They also want corporate management to identify and disclose risks associated with severe weather events and changes in related laws and regulations. A report released by the group asserts that companies may be causing global warming. The report urges management and boards of directors in emissions-intensive industries to take greater responsibility for the potential consequences,

which include flooding, higher energy usage, and harmful effects on major economic sectors, such as insurance, agriculture, and tourism.

Companies in other sectors may face different demands and questions. For example, companies that produce or deliver foods are under pressure to take more responsibility for the trend toward obesity, while pharmaceutical companies are under pressure to reduce the prices of drugs that treat AIDS and other diseases.

Some institutional investors are increasingly involved in these social and environmental issues on the grounds that a healthier society means healthier companies and higher long-term returns on their investments.

A handful of issues affect companies almost across-the-board in all industries. Most notably, the outsourcing of jobs to other countries has raised concerns in recent months, and issues involving benefits for employees and retirees seem to be gaining momentum. As a result, companies can expect questions about outsourcing, retiree

health care, cost containment efforts that limit benefits for employees, and policies that discriminate against gays or other minorities.

Some companies might get questions about sustainability reports, the term used to describe a triple-bottom-line reporting format that attempts to measure both non-financial (social and environmental) and financial performance. The Global Reporting Initiative, which is affiliated with the UN environmental program, provides guidelines and indicators for sustainability reports.

**“There is one and only one social responsibility of business—to use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game, which is to say, engages in open and free competition, without deception or fraud.”**

**Milton Friedman**, Nobel Laureate.  
*Capitalism and Freedom*  
1962

## Shareholder Questions

— Does the company issue (or is it planning to issue) a sustainability report? If not, why not?

### Environmental responsibilities

- What is the company doing to prevent or mitigate climate control risks?
- How does the company monitor its environmental risks? How much will remediation cost, and are these amounts reflected in the financial statements? Is the company insured for such claims? How confident is the company that its insurance carriers will agree and be financially able to reimburse the company for losses related to these matters?
- 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 Federal or state Environmental Protection Agency actions?

### **Social responsibilities**

- Is the company outsourcing jobs to offshore locations, making it harder for U.S. citizens to find employment?
- Do the company's products or services contribute to any unhealthy conditions, such as obesity?
- 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?
- Does the company have operations in, or trade with, countries that violate basic human rights? If so, how does the company reconcile its actions with public opinion?
- What are the company's equal opportunity policies? Does the company support quotas or affirmative action? What percentage of employees at each employment level are women, minorities, and physically challenged? Why aren't there more women and minorities in management?
- What are the company's policies for maternity leave? Does the policy include paid leave for fathers?
- What policies does the company have to prevent sexual harassment? How are the policies monitored? What course of action is taken if an employee or officer is accused of sexual harassment?
- Does the company provide child-care services for its employees? How are the benefits and costs of this program assessed?
- Does the company provide benefits for partners of gay or lesbian employees?
- Has the company reduced (or does it plan to reduce) benefits for retirees or spouses?
- What is the company doing to improve the quality of public education in the communities in which it operates?
- 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?

### **Contributions**

- To which organizations were charitable and political donations made this year? 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?

# Litigation and Other Matters

Much progress has been made over the past two years in improving corporate accountability and governance. But the financial impact of litigation, legal fees, and penalties is still all too often a no-win situation for shareholders.

In many cases following the restatements of the past few years, the consequences of alleged misconduct have led to class action lawsuits that deplete the company's directors and officers insurance, leaving the shareholders to foot the bill for some or all of the legal fees as well as any penalties levied against

the company for the actions of its former officers.

This situation, which appears to add insult to injury, results from the indemnification provisions in most companies' bylaws. Shareholders may be aware of these provisions because SEC rules require disclosure of them, resulting in questions about the indemnification provisions, as well as the costs of D&O insurance, and legal fees paid out to defend former officers against fraud allegations.

In companies where there were restatements, questions may be

raised about the severance pay granted to executives to avoid litigation after the executives were forced out for violations of accounting rules or ethics codes.

Similarly, questions may be raised about the likelihood of recovering compensation or gains from former officers, and the effects on future earnings and shareholder value of expected changes in the provisions of D&O insurance policies.

**“You may never achieve zero defects. But if you want to avoid lawsuits, try to reach that goal.”**

**Marisa Manley**

*Harvard Business Review*

## Shareholder Questions

- Do the company's bylaws contain indemnification provisions for officers and directors?

### Litigation

- What matters are currently being litigated? What is the likely outcome? How will the company avoid repeating the circumstances that originally caused the litigation? Will damages, if any, from this matter be covered by the company's insurance carrier(s)? Are there any issues about insurance coverage? If the company is a plaintiff in any actions, what are the damages claimed and how long will it take to resolve the suits?
- Has the company considered including alternative dispute resolution clauses in contracts and other agreements with its customers, suppliers, and employees?
- 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? Were any legal fees paid to lawyers who are on the company's board? How are potential conflicts of interest identified and monitored?
- Have any in-house or outside attorneys resigned or been terminated by the company during the last year? If so, what were the circumstances?
- Has the company taken any legal actions to protect its patents, trademarks, and other proprietary property?

### Other matters

- Is the company having difficulty obtaining general liability insurance or insurance for directors and officers?
- 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 have a risk assessment committee?
- 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 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 take steps to elicit feedback from customers on the level and extent of customer satisfaction?

- Given the focus on information privacy, 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?
- How have new products been received in the marketplace?
- 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?
- Has the company formulated a plan to protect against the unauthorized use of trade secrets, know-how, and other information by former key employees?
- What was the amount of fees paid to outside consultants? What services did they provide?
- Were any changes made during the previous year in the company's articles of incorporation or bylaws? What are the changes, and why were they made? Do the changes affect shareholder values?
- 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?

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*A BDO Seidman, LLP partner customarily attends the annual shareholders' meeting of each of our publicly held clients. If you would like our assistance in preparing for your annual meeting, please contact us.*

## 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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