

Public Company *Insights*

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Year End 2009

Required reading: How the SEC proposes to change proxy disclosure

The SEC recently proposed new rules for proxy disclosure and solicitation enhancements that demand the attention of all public companies. These rules are intended to improve disclosures to shareholders in annual reports, proxy and information statements, and registration statements about such topics as compensation, risk, director and nominee qualifications, and company leadership structure.

The SEC only released the rules in July, and, as of this writing, was still in the process of reviewing public comments. But it's likely that at least some of the proposed changes will be adopted in time for the 2010 proxy season.

Follow the money

Perhaps of greatest interest to many companies are the SEC's proposals regarding executive

compensation. Companies would be required to add a section to the Compensation Discussion and Analysis (CD&A) that provides information about how its compensation policies create incentives that can affect overall risk. For example, if a company awards bonuses for achieving certain performance targets, these bonuses could provide an incentive for employees to take excessive or inappropriate risks that could have a material impact on the company.

The rules would also revise the Summary Compensation and Director Compensation tables to require disclosure of the aggregate grant date fair value of stock and option awards, in accordance with Financial Accounting Standards Board (FASB) standards. Current rules require disclosure based on the dollar amount recognized for financial reporting purposes — which in many cases is substantially lower.



Tone at the top

Also proposed are items related to corporate governance and leadership, including:

Directors and nominees. The SEC has proposed expanding disclosures regarding directors' and director nominees' qualifications. This would include details on the "specific experience, qualifications, attributes, or skills that qualify" them to serve as directors. The rules would also require disclosure of directorships within the last five years (not just current directorships) and would expand the period for disclosures of legal proceedings involving directors, nominees and executives from the last five years to the last 10 years.

Leadership structure. Companies would be required to describe their leadership structure and explain why they believe it's the best structure for their organization. Some companies, for example, combine the role of principal executive officer and board chair, and designate a lead independent director to chair meetings. Under the proposed rules, such a company would have to explain the specific reasons for this structure and describe the lead independent director's role within it.

Risk management. Companies would be asked to disclose information about their board's role in the risk management process and the relationship between the board and senior management when it comes to risk. Respondents might disclose, for example, how the board implements and runs its risk management function or whether those overseeing risk management report directly to the board or to a committee.

Where best interests lie

The proposed rules also tackle the role played by compensation consultants. These advisors may have a conflict of interest if they play a role in setting executive or director compensation and also provide other services to the company, such as benefits administration or actuarial services.

To inform investors of potential conflicts, the SEC proposal would require companies to disclose:

- ▶ The nature and extent of additional services provided during the last fiscal year by the consultant or its affiliates,
- ▶ Fees paid for both compensation consulting and additional services,
- ▶ Whether management was involved in the decision to engage the consultant or its affiliates for noncompensation services, and
- ▶ Whether the board or compensation committee approved the additional services.

These disclosures would be required if the compensation consultant played *any* role in

Food for thought

In addition to the specific items discussed in the main article at left, the SEC has requested comments on several other proxy disclosure changes it may consider in the future. This includes asking companies to reveal the compensation of all executives, not just named executives.

Feedback is also requested on proposals that companies be required to disclose whether:

- ▶ Any compensation committee members have expertise in compensation matters,
- ▶ They have "hold to retirement" or "claw back" provisions,
- ▶ Executive compensation amounts reflect any internal pay equity considerations, and
- ▶ Their board conducts periodic performance evaluations of the board as a whole, its committees or individual directors.

The SEC has further invited opinions on eliminating the instruction that permits a company to exclude performance targets if disclosure would have a potential adverse competitive effect or, alternatively, requiring disclosure of performance targets after-the-fact. And the SEC might consider requiring smaller reporting companies to disclose information about their overall compensation policies.

determining or recommending the amount or form of executive or director compensation. The exception to that rule is when the consultant's role was limited to determining whether broad-based benefit plans — such as 401(k) or health care — discriminate in favor of executives or directors.

Other proposals

Under current rules, shareholder voting results are included in quarterly and annual reports. To provide more timely voting results, the proposed rules require companies to report the results of

shareholder votes on a Form 8-K within four business days after the end of the meeting at which the vote was held.

Finally, the SEC's proposal includes several clarifications and improvements to the proxy solicitation process. And it makes several requests for comments on other possible future changes. (See "Food for thought" on page 3.)

Be prepared

This may seem like a lot of information to absorb and prepare to implement. Although it's not yet clear which of the proposed changes will actually be adopted, you should, nevertheless, take this opportunity to review your company's compensation policies, leadership structures, and corporate governance and risk management practices to prepare for some major changes ahead. ■

Is your company covered by the Red Flags Rule?

In 2007, the Federal Trade Commission (FTC) issued a set of regulations, known as the "Red Flags Rule," which require covered organizations to implement a written identity theft prevention program. The FTC has postponed enforcement since issuing the rules in November 2007. However, as of this writing, the compliance deadline was extended to Nov. 1, 2009.

Contrary to what many believe, the Red Flags Rule doesn't apply only to financial institutions. It also applies to "creditors" — a broadly defined category that encompasses any business or organization that regularly extends, renews or continues credit.

Two-step process

The Red Flags Rule requires creditors, regardless of industry, to review their activities, determine whether they're required to comply with the regulations, and, if so, implement a written program to protect against identity theft by the enforcement date. Determining whether your company must comply is a two-step process:

1. Determine whether your company meets the definition of "financial institution" or "creditor."

Financial institutions include banks, savings and loan associations, credit unions, mutual funds that offer check-writing privileges and other institutions that permit consumers to make payments or transfers to third parties.

Companies with a relatively low risk of identity theft don't need as comprehensive a program as high-risk companies.

"Creditor" includes any organization that regularly defers payment for goods or services or provides goods or services and bills customers later. According to the FTC, examples of organizations that may be considered creditors (depending on how they collect payment) are utility companies, health care providers and telecommunications companies.

Creditors also include those that regularly grant loans, arrange for loans or extensions of credit, or make credit decisions. This group typically

includes finance companies, mortgage brokers, real estate agents, automobile dealers, retailers that offer or assist with financing, and third-party debt collectors.

2. If you've concluded that your company is a financial institution or creditor, determine whether you have any "covered accounts."

There are two types of consumer accounts. The first type is a consumer account that is primarily for personal, family or household purposes and permits multiple payments or transactions — such as credit card accounts, mortgages, auto loans, bank accounts, utility accounts, cell phone accounts and margin accounts.

The second type of covered account is "any other account ... for which there is a reasonably foreseeable risk to customers or to the safety and soundness of the financial institution or creditor from identity theft...." Examples include small business accounts, sole proprietorship accounts and single transaction consumer accounts.

Name specifics

If you determine your company is subject to the Red Flags Rule, develop, implement and administer a written identity theft prevention program that:

- ▶ Includes reasonable policies and procedures to identify the red flags of identity theft in your business operations,
- ▶ Is designed to detect those red flags,
- ▶ Spells out appropriate actions to take when red flags are detected, and
- ▶ Establishes procedures for re-evaluating your program periodically to address new risks.

The details of your program depend on your company's size and risk profile. Companies with a relatively low risk of identity theft, for example, don't need as comprehensive a program as high-risk companies.

The specific red flags your program must identify depend on the nature of your business and its activities. Common categories of red flags include alerts from credit reporting companies, suspicious documents (such as fake IDs), suspicious personal information (such as an address that doesn't match a credit report) and unusual account activity (such as an account that's been inactive for a long time and is suddenly used again).

Capturing the flags

If the Red Flags Rule applies to your company and you've put off complying with it, wait no longer. Develop a plan and ask your board of directors to approve it.

The employee running your company's program also needs to report at least annually to your board or senior management, who, under the rule, are responsible for its management and compliance. Failure to comply with Red Flags Rule requirements could result in a penalty of up to \$2,500 for a "knowing violation." ■



Dispatches from the bumpy road to IFRS

At the end of 2008, the SEC published its long-awaited “roadmap” for converting U.S. companies from Generally Accepted Accounting Principles (GAAP) to International Financial Reporting Standards (IFRS) over the next few years. Progress toward that goal has stalled as regulators grapple with the country’s financial crisis, but the destination remains the same. To avoid getting left behind, be sure to keep up with IFRS developments.

Fair value updated

The International Accounting Standards Board (IASB) has proposed its own fair value rule that’s derived in large part from the Financial Accounting Standards Board’s (FASB’s) fair value measurements rule, formerly referred to as FASB Statement of Financial Accounting Standards No. 157 and now covered under FASB Accounting Standards Codification™ (ASC) 820, *Fair Value Measurements and Disclosures*. Like ASC 820, the IASB’s exposure draft (ED), *Fair Value Measurement*, defines fair value based on a market participant’s exit price. It also provides guidance similar to the FASB’s recent guidance on measuring fair value when the market for an asset or liability is inactive.

There are, however, several differences between the IASB’s proposal and ASC 820. For example, the IASB proposal would value an asset or liability based on the price that would be paid in the most advantageous market to which the reporting entity has access — in other words, the market that would produce the highest price. ASC 820, on the other hand, assumes that the transaction takes place in the entity’s “principal market,” relying on the most advantageous market only in the absence of a principal market.



MD&A guidance explained

Recently, the IASB issued an ED that would provide guidance on preparing management commentary (Management Discussion & Analysis or MD&A) to accompany financial statements prepared in accordance with IFRS. The ED calls for nonbinding guidance, rather than a new standard, that provides a framework to assist management in preparing “decision-useful” management commentary. Such commentary:

- 1. Provides management’s view of the entity’s performance, position and development.** Such information that’s important to management in managing the business is also important to financial statement users.
- 2. Supplements and complements financial statement information.** This includes financial and nonfinancial details about the entity and its performance that isn’t included in the financial statements.

3. Is future oriented. It discusses factors that could affect the entity's financial performance in the future, and the extent to which forward-looking disclosures made in prior periods have been borne out.

Financial instruments defined

Recently, as part of its ongoing project to replace International Accounting Standard (IAS) 39, *Financial Instruments: Recognition and Measurement*, the IASB issued an ED on *Financial Instruments: Classification and Measurement*. According to this ED, a financial asset or liability would be measured at amortized cost if two conditions are met. First, the instrument must have basic loan features. And second, the instrument needs to be managed

on a contractual yield basis. A financial asset or liability that doesn't meet both conditions would be measured at fair value instead.

The impact of this ED on a company's fair value will depend on the organization. Factors include the organization's financial instruments, how it has classified them in the past and certain choices it's permitted to make under the proposed standard.

Real time

There's still some uncertainty about when U.S. companies will be required to adopt IFRS. But you can help ease the transition for your company by monitoring events as they happen. ■

How the IC-DISC helps exporters defer taxes

Tax incentives for exporters already are few and far between, and lawmakers may soon impose additional limits on them. In anticipation, an increasing number of public companies are taking advantage of a valuable, but often overlooked, tool: the interest-charge domestic international sales corporation (IC-DISC).

Not just for private companies

IC-DISCs have been authorized by the Internal Revenue Code since 1972. But until recently, they were used primarily by closely held companies because public companies often had more lucrative tax breaks available. Now more public companies are looking for the liquidity boost IC-DISCs can provide. IC-DISCs are shell corporations established to receive commissions on export sales. To qualify, the corporation must:

- ▶ Be a C corporation organized in the United States,
- ▶ Elect to be treated as an IC-DISC for tax purposes,
- ▶ Maintain a minimum capitalization of \$2,500,
- ▶ Offer a single class of stock, and
- ▶ Maintain income and assets that are 95% attributable to qualified export property.

Qualified export property is manufactured or produced in the United States with at least 50% U.S. materials, and is sold primarily outside the country. The exporter pays tax-deductible commissions to the IC-DISC of up to 4% of its gross receipts from sales of qualified export property or 50% of its net income on those sales, whichever is greater. The IC-DISC itself is generally tax-exempt.

When in doubt, defer

IC-DISCs allow companies to indefinitely defer taxes on up to \$10 million per year of commission income, providing a valuable liquidity cushion as well as a rainy-day fund for future working-capital needs. Closely held companies also can use an IC-DISC to convert ordinary income into dividend income (which currently is taxed at only 15%). If a parent company elects to defer IC-DISC income, it must pay an interest charge each year (the "IC" in IC-DISC). But interest is tied to the T-Bill rate — a modest 2% or lower in recent months.

As with most things tax-related, there's no guarantee that Congress won't soon eliminate the IC-DISC or limit its benefits. However, IC-DISCs are simple and inexpensive to set up, and they quickly pay for themselves in the form of immediate tax benefits.