



## ***IR Issues Alert***

# **Get Ready for Real-Time Disclosure**

## **In the aftermath of Enron, the SEC proposes profound changes to current disclosure regime**

In the aftermath of the tragic effects that the collapse of Enron Corporation has had on market confidence, as well as on Enron's employees and investors, Congress and the Securities and Exchange Commission are moving in a rapid and united fashion to implement significant changes to accounting and securities disclosure rules.

### **Emerging IR Issues**

The decades-old periodic disclosure regime is moving very rapidly toward a new world of real-time disclosure of material information. The purpose of this IR Issues Alert is to highlight specific proposals that are being drafted by the Securities and Exchange Commission or the Financial Accounting Standards Board (FASB), with the intention that such proposed changes be adopted within the next few months. At the heart of these proposals is the belief by many lawmakers and regulators that investors depend in large measure on the integrity and stability of our capital markets for their personal wealth and security. As a result, the burden of responsibility and accountability for fair and complete disclosure must be substantially assumed by the directors and management of public companies, as well as by their advisors.

In this context, SEC Chairman, Harvey Pitt, has proposed the following changes to disclosure rules:

1. Provide accelerated reporting by companies of transactions by company insiders and company securities, including transactions with the company;
2. Accelerate filing by companies of their quarterly and annual reports;
3. Expand the list of significant events requiring current disclosure on Form 8-K. Such events could include changes in rating agency decisions, obligations that are not currently disclosed and lockout periods affecting employee stock ownership plans.
4. Add a requirement that public companies post their Exchange Act reports on their web sites at the same time that they are filed with the SEC; and
5. Require disclosure of critical accounting policies in Management's Discussion and Analysis of Financial Condition and Results of Operations, contained in annual reports.

### **Amendments for Insider Trading**

With respect to reporting transactions by company insiders in company securities, Mr. Pitt noted that currently, trades must be reported by the tenth day of the month following the month in which the trades occur. This results in a delay of up to 40 days. The new rules require disclosure "*on a current basis*" of significant transactions in the company's stock by their executive officers and directors. Such disclosure would be required through direct reporting

on the EDGAR system, and presumes that in many cases, significant transactions should also be reported publicly through a press release.

## **Annual and Quarterly Reports**

Presently companies are required to file their annual report on Form 10-K within 90 days following the year end, and quarterly reports on Form 10-Q within 45 days following the quarter's end. The new proposed rules will require companies to file their annual reports on Form 10-K within *60 days*, and Form 10-Q within *30 days* following the period's end. The Commission notes that the above time periods have not changed in over 30 years despite the fact that technology has accelerated the ability of companies to collect and assess information.

## **Additional Items Requiring Disclosure**

"The Commission believes that markets and investors need more timely access to a greater range of important information concerning public companies than is required by the existing reporting system." Presently, a limited number of corporate items are required to be disclosed pursuant to the filing of a Form 8-K, which is required to be filed within 15 days after the event. The new rules propose that an Form 8-K be required to be filed no later than the *second business day* following the occurrence of the following:

- Changes in rating agency decisions and other rating agency contracts;
- Transactions in the company's securities, including derivative securities, involving executives, officers and directors;
- Defaults and other events that could trigger acceleration of direct contingent obligations;
- Transactions that result in material direct or contingent obligations not included in a Prospectus filed by the company with the Commission;
- Offerings of equity securities not included in a Prospectus filed by the company with the Commission;
- Waivers of corporate ethics and conduct rules for officers, directors and other key employees;
- Material modifications to rights of security holders;
- Departure of the company's CEO, CFO, COO or President (or persons in equivalent positions);

- Notices that reliance on a prior audit is no longer permissible, or that the auditor will not consent to use of its report in a Securities Act filing;
- Definitive agreement that is material to the company (negotiations of agreements would be excluded from this requirement unless and until a definitive agreement is entered into);
- Any loss or gain of a material customer or contract;
- Any material right-off, restructuring or impairment;
- Any material change in accounting policy or estimate;
- Delisting of the company's securities or movement from one quotation system or exchange or another; and
- Any material events including the beginning and end of lockout periods regarding the employee's benefit, retirement and stock ownership plans.

Clearly this dramatically broadens the number and type of reportable items, thereby requiring a careful real-time assessment of corporate events that were traditionally not considered sufficiently material to disclose.

## **Disclosure on Company Websites**

The proposed new rules require that disclosure also be made more readily available to investors in "a variety of locations." To further this goal, the Commission proposes that companies post their Exchange Act reports that would include 10-Ks, 10-Qs and 8-Ks *on the company's Internet website*, if available, at the same time that they are filed.

This requirement obviously imposes an additional burden on management, legal counsel and investor relations counsel to prepare and coordinate the distribution of such information to the company website following a disclosure by a press release.

## **Disclosure of Critical Accounting Policies**

The new rules will affect Management's Discussion and Analysis of Financial Condition and Results of Operations (MD&A) to require disclosure of critical accounting policies. "Proposals may require public companies to include in their MD&A full explanations, in clear and understandable format and language, of their critical accounting policies, the judgements and uncertainties affecting the application of these policies, and the likelihood that materially different amounts would be reported under different conditions or using different assumptions. The objective of this disclosure would be consistent with the objective of MD&A to provide

information on events or uncertainties known to management that would have a material impact on reported financial information. Such disclosure would assist investors in understanding a company's financial condition, changes in financial condition, and results of operations."

## Potential Accounting Treatment Disclosure Changes

Separate from the Securities and Exchange Commission proposals with respect to broader and more timely disclosure, various accounting regulatory agencies are evaluating changes to company financial statements and footnotes. Among the more significant are:

- **Disclosure of off-balance-sheet items**  
Many companies use "Special Purpose Entities" (SPEs), which have been made much more visible following the Enron collapse. FASB hopes to have rules in place soon that will require that such SPEs be consolidated onto the sponsor's balance sheet so as to reflect the "essence of the economics of the contract as opposed to specific rules." Clearly, accounting firms, audit committees and lawyers will need to more carefully evaluate the role of the SPE, and provide more transparent disclosure on the company's financial statements.
- **Highlight Material Trends**  
The FASB has attempted to clarify that items quantified to 5% or 10% of earnings or assets were previously considered immaterial to the overall performance and could be left out of the financial statements. Accounting standard boards and the SEC are proposing that additional evaluation of these smaller items be made so that, if they represent collectively an important trend, such items should be disclosed. This was brought to light recently in connection with Tyco Corporation, which made hundreds of acquisitions totaling \$8 billion with a relatively small percentage of them disclosed. They took the position that each acquisition was relatively small and immaterial. However, in the aggregate, they represented a significant component of the financial condition of the company.
- **Standardize Operating Income**  
A variety of competing proposals are circulating dealing with so called pro forma operating earnings. The current disclosure best practices provide for

sufficient detail contained within the pro forma financial results to show what was added or subtracted from GAAP net income to arrive at the pro forma results. Further, it is suggested that both the GAAP results and the pro forma results be included in the same press release and disclosure documents.

- **Clarify Free Cash Flow**  
Investors are increasingly interested in how much cash, net of interest and other obligations, a company will generate in the future. In most cases, additional information is required to allow investors to make this calculation. Such tools are being debated presently by a variety of agencies, and will most likely be required to be included in future MD&A.
- **Additional Scrutiny of Equity Compensation Plans**  
Equity compensation plans have drawn increased scrutiny from both regulatory bodies and investors. A consensus is developing among accounting standards boards that stock options issued under equity compensation plans should be expensed and deducted from income, which will diminish their value as a management incentive tool. Further, the SEC recently adopted final rules requiring increased disclosure of a company's equity compensation plan. A particular focus of increased disclosure is the requirement that equity compensation plans be aggregated into two groups: those plans or agreements that have been approved by shareholders and those that have not. In the future, it will clearly be more difficult to implement equity compensation plans without stockholder approval.

## Summary

Significant changes will be adopted in the coming months, impacting corporate disclosure and the preparation of financial statements. Thoughtful management and boards of directors will begin today evaluating the impact of such changes by bringing together all the relevant parties, including senior management, legal counsel, public accountants and investor relations counsel. Through this collaboration, forward-thinking policies can be evaluated, adopted and implemented concurrent with, or in advance of, these changes so as to minimize to the greatest degree possible dislocations within the company, and to maximize credibility of management among company customers, employees, shareholders and investors.



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