



# Financial Reporting

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## Shareholder Questions – 2005

*BDO Seidman, LLP prepared this Financial Reporting letter to help our clients anticipate and respond to questions that may be asked in 2005.*

The 2005 proxy season follows a three-year blizzard of regulatory reforms, and it arrives in a new era of corporate governance. Professional proxy advisors are using the power of the Internet to rally support for withholding votes. Through just-vote-no campaigns and related shareholder resolutions, investors are joining together to gain a greater say in such critical matters as how directors are elected and how senior executives are compensated. These big-company tactics help shape the issues for smaller companies.

In addition to executive pay and director elections, this year's key areas of concern reflect the headlines of the past year. Well-publicized SEC enforcement actions and trials of former corporate executives serve as vivid reminders of past business and reporting failures. Because these events shine a spotlight on overall business ethics, companies can expect questions about fraud prevention and codes of conduct.

Companies can also expect questions about the effects on their earnings and financial condition of legislative, regulatory and standard-setting changes. Internal control reporting, new tax laws, and changes in accounting rules are all likely to trigger questions. Companies should be prepared to address complex topics ranging from stock-based compensation plans, aggressive tax strategies and uncertain tax positions to how their shareholder communications practices stack up against emerging best practices.

### The Legislative and Regulatory Environment

Shareholders are likely to raise questions about the effects on their investments of the current legislative and regulatory environment. A key cause for concern is the explosion of class action lawsuits in recent years. Some of these lawsuits were triggered by business and reporting failures that resulted in well-publicized trials of former executives. Increasingly, the media has been reporting large corporate settlements, often at the shareholders' expense.

#### Tort Reform

In response to business and shareholder concerns, the courts have reconsidered key issues involved in preventing and enforcing violations of the federal securities law.

Under a recent ruling by the Supreme Court, investors who allege losses due to misrepresentation by companies must show that the misrepresentations were to blame for their losses.

In addition, lawmakers have re-examined the legal system governing tort actions (misdeeds that cause personal injury). In early 2005, the Class Action Fairness Act was signed into law. The new law is expected to help curb future settlements of tort actions by making it easier for defendants to move many multi-state class actions into federal court.

Legislators continue to debate possible reforms for other types of tort actions. Several bills have been introduced in Congress in an effort to reform areas of law ranging from employment and consumer protection to environmental and securities laws.

#### Settlements of Lawsuits

At the same time, plaintiffs in some class action lawsuits have pressured corporate directors to dig into their own pockets and pay up personally for fraud they didn't commit or perhaps even know about. The two ground-breaking settlements in this regard involved alleged securities law violations at WorldCom and Enron.

These settlements set precedent for other plaintiffs to force corporate directors to make personal restitution for corporate misdeeds, despite legal indemnifications and D&O insurance.

Although SEC rules require disclosure of indemnifications of officers and directors, the full indemnifications may not apply in certain circumstances, making it difficult for investors to discern the impact on the company's earnings and financial condition.

#### Effect of S-OX

The Sarbanes-Oxley Act of 2002 was intended to address a lack of confidence in businesses and the U.S. capital markets. Yet the costs of compliance have been high. Shareholders may question these costs and whether they are getting suffi-

cient value in exchange for the costs—a subject covered in more detail in the section of this letter on "Audits and Audit Committees."

#### Other Regulatory Issues

Shareholders may also question the effects of other current regulatory issues of broad consequence. For example, the Bush Administration is considering a range of proposals designed to protect pension benefits for workers and retirees. Some of these proposals suggest changes in how companies fund their defined benefit employee retirement plans.

Other areas targeted for reform include the environmental monitoring rules, the rules for handling and disposing of hazardous substances, and the rules implementing the Family and Medical Leave Act.

## Shareholder Questions

### Effects of recent legislative and regulatory changes

- What types of tort reform would be most beneficial to the company?
- Was the company affected by the rush to file lawsuits in anticipation of the signing of the Class Action Fairness Act?
- Is the company having difficulty obtaining general liability insurance or insurance for directors and officers?
- How much is it costing the company to comply with 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? If so, how would current shareholders be assured that they will receive a fair price?
- Has the SEC or any other regulatory body investigated the company or its management or questioned any of its reporting practices? What is the status of the matter, and what is management doing to resolve the issues?
- Has the company had any difficulty maintaining its stock exchange listing?
- Were any of the company's products taken off the market due to decisions by the FDA or other government agencies? What is the impact on revenues and earnings?
- How have the overtime changes under the 2004 overhaul of the Fair Labor Standards Act affected the company and its workforce?
- How will the company be affected by the proposed changes in funding requirements for pension plans?
- Are there any other regulatory changes currently under consideration by the Bush Administration that would have a significant effect on the company?

### Pending 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 pending litigation be covered by insurance? 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?
- 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 legislative and regulatory matters

- Why has it taken so long for the company's patent applications to be approved? Why does it take so long for FDA or other approvals to be obtained? What is the likely impact on sales and earnings if they are (or are not) obtained?
- How does the company protect the integrity of existing patents, technology, and intellectual property overseas?
- Is the company in compliance with immigration rules and regulations? How is this compliance monitored?
- 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?
- Is the U.S. Customs Service investigating the company's importing and exporting practices? If so, what is the status of the investigation?
- 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?
- How will the Medicare Drug Subsidy affect the company's retirement and benefit plans?
- 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?
- 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?

### Boards of Directors

The criteria for good corporate governance have been subjected to considerable scrutiny in recent years. Increasingly, shareholders view the independence, qualifications and elections of boards of directors as the centerpiece of good governance, making this a fertile area for shareholder questions. In addition, reforms under consideration by the SEC have provided a powerful and revolutionary force for proxy advisors and shareholder activists who want to exert more influence over the elections of directors. Currently, at some companies, a director can be elected on a single vote—a process that may seem unfair to shareholders.

#### Voting for Directors

The push for greater shareholder involvement in electing directors began to gather speed with the SEC's 2003 proposal to allow shareholders to vote for directors. This proposal drew strong support from shareholders and strong opposition from businesses.

In effect, the SEC's proposed shareholder access rule identifies certain triggers that, if met, would allow qualified shareholders to gain access to the proxy ballot to nominate directors. One of the triggers is a withhold vote exceeding 35 percent.

Proxy advisors and shareholder activists reacted to the SEC's proposal in several ways. First, they organized withhold vote or just-vote-no campaigns as a way to make their opposition known on the elections or re-elections of certain directors. Second, some activists submitted shareholder resolutions under which a director would not be reelected if he or she did not receive a majority of the proxy votes. Third, the SEC's proposal renewed shareholder questions and concerns about "staggered" or "classified" boards, meaning boards in which

not all the directors stand for re-election each year.

Since issuing the proposal, the SEC has been split in its views on how to proceed. In late 2004, the SEC staff blocked several shareholder resolutions designed to help shareholders nominate candidates for boards of directors. However, in a letter to lawmakers in March 2005, SEC Chairman William Donaldson said the staff's decisions were based on long-standing rules. He said the Commission continues to consider whether there is a shareholder access rule it should adopt.

#### Independence of Directors

Another regulatory initiative that is having a profound effect on proxy voting is the adoption of rules about directors in 2003 by both the New York Stock Exchange and the Nasdaq Stock Market. Listed companies were required to comply with these rules in 2004. The rules require that boards have a majority of independent directors. They also strengthen the definition of an independent director and the required duties of board committees.

Because the listing rules demand a high level of involvement on the part of directors, they have raised concerns that some directors may have overextended themselves by serving on too many boards.

The independence requirements have also triggered questions and concerns about companies that may be seen as bending the rules by going just beyond the bright-line tests of compliance set by the exchange listing rules. For example, a director is not considered independent if he or she had any material dealings with the corporation for the past three years. Shareholders may question a company that complies with this rule by a slim margin, such as three years and a day.

Other potential causes of concern include any fee arrangement that might be seen as a conflict of interest. Examples that have been challenged in recent months include fees paid to an audit committee chair in connection with an investigation and donations by a CEO to charities run by board members.

Questions may also arise about the length of the cooling off period if a former CEO is appointed to the board. In some companies, shareholders may question the definition of a relative. Under the NYSE exchange listing rules, a director is not independent if a relative receives more than \$100,000 in consulting fees or certain types of compensation other than salary.

Recent actions by the SEC have underscored the importance of disclosures in this regard. In late 2004, the SEC brought an administrative action against Walt Disney Company for failing to disclose that it employed the children of directors.

## Shareholder Questions

### Independence of directors

- Do any directors serve on multiple boards? How many boards?
- How does the company monitor the continued independence of board members?
- What are the compensation arrangements for directors? How much are directors paid for attending board meetings? What perks do directors receive?
- What is the full extent of any dealings between any of the directors and the company during the past X years?
- Has the company employed or paid any fees to relatives of any of the directors?
- Has any outside director made recommendations to management regarding the possible employment of any individuals? How are possible conflicts of interest avoided in these situations?
- Have any senior officers made significant donations to charities run by board members?
- How are potential conflicts of interest identified and monitored?
- Do directors sign conflict-of-interest statements prior to their appointments to serve?
- Are any of the directors also board members of companies that either compete or do business with the company?
- Did any board member abstain from voting as a result of a conflict of interest? If so, what were the circumstances? What can be done to avoid conflicts in the future?

### Voting for directors

- What are the company's views on majority voting for directors and shareholder access to proxy statements for purposes of nominating directors?
- Has consideration been given to cumulative voting for the election of directors? (Cumulative voting entitles shareholders to as many votes as the number of shares they own multiplied by the number of directors to be elected.)
- What was the attendance record of each director at board meetings and board committee meetings last year?
- Why aren't there more independent directors on the board?
- How many directors are women or minorities? What actions are being taken to ensure diversity on the board?
- Are all directors shareholders? Does the company encourage directors to own shares in the company?
- 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?
- Are there any age limits imposed for serving as a director? If not, then why not?

### Activities of the board of directors

- How often does the board meet? Where were the meetings held?
- Are executive sessions of non-management directors held regularly?
- What were the major areas addressed at the board level this past year?
- 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?
- Does the board play a significant role in strategic planning? If a significant shift in strategy is contemplated, is the board consulted before final decisions are made?
- Are there separate boards of directors for each subsidiary? Are the separate boards encouraged to act independently from the parent company? Are the costs of separate boards justified by the benefits?
- Does the company indemnify directors in the event litigation arises which relates to possible conflicts of interest or negligence of the board? Does the company provide D&O liability insurance to members of the board?
- What factors are considered in the selection process for the chairman of the board?
- Has the board considered separating the roles of chairman of the board and chief executive officer?
- Did independent directors review and sign the annual report filed with the SEC? Did any directors refuse to sign?
- 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?
- Has the board developed corporate governance guidelines?

### Executive Compensation

Questions about executive compensation are likely to reflect shareholders' desire to curb excessive pay, ensure all forms of compensation are fully disclosed, and hold directors accountable for abuses of CEO pay. This year's questions and concerns center around five main themes: (1) limits on executive pay, (2) undisclosed executive perquisites, severance and retirement pay, (3) alignment of pay with performance, (4) voting on equity-based compensation plans, and (5) paybacks of executive bonuses when financial statements are restated.

#### Limits on Executive Pay

Activists seeking to limit executive pay have suggested caps expressed as ratios of an executive's pay to average compensation paid to other employees. For example, a cap might be set at 100 times the average compensation paid to the company's non-managerial workers in the prior fiscal year. These activists reason that if a company wants to pay more, it should explain why and then put the matter on the proxy for a shareholder vote.

#### Disclosures about Pay

Shareholders have grown increasingly concerned that companies may seek to avoid controversy over the levels of their executive pay by lowering a CEO's salary and increasing other forms of undisclosed compensation (sources of "stealth wealth") for senior executives. These concerns have been heightened in a year marked by CEO ousters and reports of lavish severance and retirement pay.

The SEC has expressed similar concerns about disclosures. In 2004, the Commission announced the settlement of an enforcement

action against General Electric Company for failure to fully and accurately describe the retirement benefits a former CEO was entitled to receive from the company under an "employment and post-retirement consulting agreement."

The SEC staff has indicated it is considering the following topics for potential rule-making activity: (a) more detailed disclosures about perquisites, retirement benefits, and deferred compensation, (b) enhanced disclosures of total compensation, and (c) other possible changes, such as an expansion of the disclosure requirements for director compensation, the inclusion of additional executive officers (beyond those currently required), and the inclusion of related party transactions that affect executive compensation.

Recent SEC rule changes have already expanded the level of 8-K reporting for matters related to executive pay. Following the release in late 2004 of an SEC FAQs document, companies have begun to report on Form 8-K the entry into agreements, including at-will oral agreements and/or bonus arrange-

ments with named executive officers and other executive officers

Proxy advisors have gone a step further and are requesting voluntary disclosures of additional information not currently required under SEC rules. The SEC's rules require disclosures of benefits only if they exceed \$50,000, and separate disclosure of perks only when valued at more than 25 percent of the total compensation. This means a relatively substantial portion of executive compensation may not be sufficiently transparent to allow investors to judge the alignment of pay with performance, either in the past or in various future scenarios.

#### Pay-for-Performance

Under SEC guidelines, the proxy must include a compensation committee report addressing the company's executive compensation policies and practices, the basis for compensation paid to the CEO for the last completed fiscal year, and the relationship between executive pay and corporate performance.

Research reports show a significant number of companies are voluntarily increasing the length of their compensation committee reports this year. The most common changes involve more disclosures about equity-based compensation and executive benefits.

But proxy advisors want further disclosures and more accountability. Increasingly, they are urging shareholders to raise the question, "Has the compensation committee indicated how they have improved performance?" Some shareholder activists recommend withholding votes from the compensation com-

mittee members, if they have not provided this information in a public filing.

### Equity-based Plans

Shareholders seeking to place limits on executive pay may view stock options and other share-based payments as a way to hide excessive executive compensation. Under rules of the New York Stock Exchange and Nasdaq Stock Market that were approved by the SEC in 2003, companies must obtain shareholder approval of any plan that provides stock or options as compensation. These rules also require approval for repricings and material plan changes.

Shareholders may be confused about how to evaluate these equity-based plans prior to the company's adoption of FASB Statement No. 123R, *Share-Based Payment*. Shareholder activists may prefer that the company voluntarily expense the

cost of share-based payments, even though the SEC has said the accounting standard does not need to be adopted until the beginning of the first fiscal year that begins after June 15, 2005 (December 15, 2005 for small business issuers).

In addition, reports of proxy advisors may stir questions about the plan's burn rate (the total number of equity awards granted in any given year divided by the number of common shares outstanding). These advisors reason that a high burn rate increases the likelihood of dilution of the shares held by non-employee shareholders who are not permitted to participate in the plan. A high burn also leads to more frequent requests for shareholder approval for new shares.

Some proxy advisors recommend voting against a company's equity plan with a three-year average burn rate that is high relative to the relevant industry average and is

greater than 2 percent of the company's outstanding shares.

### Paybacks of Bonuses

Section 304 of the Sarbanes-Oxley Act requires that CEOs and CFOs pay back any bonuses based on performance targets met in financial statements that were subsequently restated for noncompliance with financial reporting requirements.

Shareholders may ask if companies have revised their long-term incentive compensation plans to provide for the recovery of these bonuses. Without such revision, it is difficult for shareholders to assert their rights; only the SEC could force a payback. Section 304 also applies to profits realized on sales of securities by CEOs and CFOs during the 12-month period following the filing of the original (prior to restatement) financial statements with the Commission.

## Shareholder Questions

### Limits on executive pay

- 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?
- How does the company justify the huge differential between its highest-paid executive and lowest-paid worker?
- Is officers' compensation comparable to that of similar companies? Is there a ceiling on officers' compensation?
- Does the company use outside executive compensation consultants?
- 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?
- Are management perks, severance pay, 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?

### Pay for performance

- What correlation is there between executive compensation and the market price of the company's stock?
- What steps has the company taken to ensure management pay is tied to performance?
- Is compensation based on subjective factors, a specific formula, or other objective criteria? Are compensation awards effective in increasing shareholder value? Do all members of management own stock in the company?

### Shareholder Questions (continued)

- 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?
- Have the company's long-term incentive compensation plans been revised to provide for the recovery of bonuses in accordance with the provisions of the Sarbanes-Oxley Act?

### Disclosures about executive pay

- Are there any forms of retirement benefits, perquisites, or deferred compensation that are not disclosed in public filings?
- Are there any undisclosed at-will oral agreements and/or bonus arrangements with senior officers of the company?
- Has the compensation committee reported on how they have improved the company's performance?
- Does the company have any special executive compensation agreements that are triggered in the event the company becomes the target of an unsolicited takeover or merger offer (i.e., "golden parachutes")? If yes, why does management believe these arrangements are in the best interest of the company and its shareholders?
- What benefits are payable to officers in the event of termination? Have any significant termination benefits been paid in recent years?
- Have all loans to officers and directors been repaid in compliance with the Sarbanes-Oxley Act?
- What steps has the company undertaken to comply with the accelerated reporting deadlines on insider transactions?
- Did the company pay for financial planning, tax, or legal services rendered to executives or retired executives by its external auditors, attorneys, or others?
- 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?
- What is the nature of any interlocking directorships or other dealings between the company's officers and the independent directors on the board or executive compensation committee?
- Has the company taken any actions to protect executives' pensions in the event of bankruptcy?
- To what extent are incentive stock options used to compensate management or other employees? Does the company have an employee stock ownership plan (ESOP)? What are the advantages of the ESOP and is it effective in increasing shareholder value? Are sales of company stock restricted by the plan?

### Equity-based plans

- When does the company expect to adopt the fair value method of accounting provisions of FASB Statement 123(R), *Share-Based Payment*, to account for employee stock options? Is the company considering any changes in compensation strategies as a result of the new accounting standard?
- Do any of the company's equity-based compensation plans have high burn rates relative to industry averages?
- 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?
- Does the company plan to curb its use of employee stock options? If so, will it issue restricted stock instead?
- 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? 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?
- Did the company accelerate the vesting of any stock options? If so, why?

### Audits and Audit Committees

The Sarbanes-Oxley legislation and related rule-making introduced important changes in audits and a special role for audit committees in corporate governance.

Most notably, Section 404 of the Act requires reporting on internal controls and identification of material weaknesses. The Act also imposed a lengthy list of enhanced responsibilities on audit committees whose role is to oversee financial reporting, external auditing, and internal compliance.

Shareholders are likely to have questions about both the audit committee's role and the internal control reporting.

#### Internal Control Reporting

The Sarbanes-Oxley Act requires that CEOs and CFOs state their responsibility for internal control over financial reporting in their certifications to quarterly and annual SEC reports.

The Act also requires that both management and the auditor evaluate the effectiveness of these controls as of the end of the fiscal year and provide the results of their reviews in the company's annual report. Larger companies' annual reports already reflect this requirement; others will need to comply for fiscal years ending on or after July 15, 2006.

Depending on which category a company falls into, shareholders will likely have questions about the company's compliance with, or readiness for, internal control reporting. They may also question whether management and the audit

committee have other policies and procedures in place to prevent and detect fraud.

Another key concern this year is with the cost/benefit tradeoff of Section 404. Shareholders may have read that some companies have postponed transactions or investments as part of their first-time efforts to comply with Section 404. This raises questions about subsequent years' efforts and how companies will get maximum value from continued compliance with the internal reporting requirements.

#### Role of Audit Committees

The requirements of the Sarbanes-Oxley Act and related rule-making have renewed the sense of constructive tension between companies and auditors.

Ultimately, auditors are accountable to the audit committee as the shareholders' representative. Several recent developments may cause shareholders to question whether the audit committee is fully engaged in deliberate oversight of the auditors, or is doing its job by rote and merely ticking off boxes on checklists.

First, there have been reports of companies with big differences between book and tax incomes, signaling that these companies may be overly aggressive in reducing taxable income.

Second, there have been reports of abuses of tax shelters including some that may involve officers of the company.

In response to these first two developments, taxes have become more of a boardroom issue, appearing on the agendas of audit committees. As a result, shareholders may question the audit committee's oversight of both taxes and the internal control reporting requirements. They may want to know what the audit committee is doing to assess tax-related risks, where the company stands in the process and what role the audit committee is playing in ensuring that any deficiencies are properly identified and remediated.

The third major development is that the SEC has clarified the rules on contingent fees, and the Public Company Accounting Oversight Board has proposed certain rules concerning auditor independence.

Under the PCAOB's proposal, auditors would not be considered independent if they provide tax services that involve contingent-fee arrangements with clients or services that involve planning or opining on the tax consequences of certain transactions. Auditors also would be prohibited from providing tax services to officers in a financial reporting oversight role.

### Shareholder Questions

#### Internal controls – Compliance (Accelerated filers)

- What are the implications of an adverse opinion on the effectiveness of internal controls? What are the implications of a disclaimer?
- What impact did disclosure of a significant deficiency or material weakness have on the stock price?
- Did the company experience any significant resource constraints or delays in complying with Section 404?
- What are the implications of a late filing of a report (either on the financial statements or on internal control)?
- If a material weakness was identified, is it a pervasive issue across the company? Or is it limited to a specific account location or account balance? What is management doing to remediate the weakness and strengthen controls in these areas?
- If lesser deficiencies were identified either by management or BDO Seidman, how was it determined that either individually or in the aggregate these deficiencies didn't rise to the level of material weakness requiring disclosure and remediation?
- Were there matters that were initially identified as material weaknesses that were ultimately classified as significant deficiencies and not disclosed? What were the criteria used to make the evaluation?
- Were there any disagreements with the auditors regarding the ultimate evaluation of matters as significant deficiencies versus material weaknesses? How were they resolved?
- Were audit adjustments identified but not recorded? Did the audit committee concur with the decision not to record the adjustment? How did the discovery of the adjustment impact the 404 process and the assessment of internal control?
- Were any material weaknesses identified but not reported because they were corrected before year-end?
- How was materiality evaluated? On the basis of impact on the income statement, balance sheet, or both?
- What were the costs of complying with Section 404, and what is the company doing to ensure maximum benefits are derived from these costs? How will the costs change in year 2?

#### Internal controls – Readiness (Non-accelerated filers)

- Will the company be ready to perform its annual evaluation, testing, and reporting on the effectiveness of its internal financial reporting controls by the deadline of the new SEC rules? Will outside resources be used?
- Has the company implemented the recommendations of the Treadway Commission or the related Committee of Sponsoring Organizations 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?
- Has the company established policies and procedures for disclosing internal accounting control deficiencies and frauds identified to the auditors and the audit committee?

#### Internal controls – Other

- 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? 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?

## Shareholder Questions (continued)

### Fraud prevention and detection

- How do the financial statement audit and the 404 audit consider the risk of fraud, including both financial statement fraud and misappropriation of assets?
- Did the Section 404 assessment identify fraud on the part of senior management?
- Does management adequately evaluate the risk of fraud throughout the organization? What is management doing to deter and detect fraud?
- Does the company have a documented procedure for following up on all reported issues through the company's hotline?
- How were reported issues resolved during the year?
- Has the company appointed a chief compliance officer?
- What is the audit committee's responsibility for fraud awareness and detection?
- How does the audit committee address the risk of management override of controls?

### The audit committee

- How did/will the Sarbanes-Oxley Act, along with the rules adopted by the SEC and the various stock exchanges, improve the workings of the audit committee?
- What criteria are used to select the members of the audit committee? What are their qualifications and backgrounds?
- Does the company's present audit committee include at least one financial expert under the new SEC definition? Who is (are) the financial expert(s) on the audit committee? What are the qualifications of the financial expert(s)?
- How are the qualifications of the "non-financial expert" members of the audit committee assessed?
- Does the audit committee receive continuing education?
- Has the audit committee performed a self-assessment in the past year? What changes were made?
- Does the company believe the tasks being performed by the company's audit committee are in compliance with the Sarbanes-Oxley Act and related SEC rules and applicable stock exchange requirements? Does the audit committee have a charter?
- 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 D&O 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?

### The audit committee's responsibilities

- Did the audit committee implement a whistleblower policy? Did the audit committee develop a complaint system to receive, retain, and treat complaints? Who monitors complaints in the company?
- 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 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?

### Shareholder Questions (continued)

- 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?

### The audit committee's oversight of tax risks

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

### Relationship with auditors

- How were the external auditors selected?
- What factors are considered in the evaluation of whether the external auditors are independent?
- Did the company enter into any arrangements with the auditor involving contingent fees?
- Did the auditor provide any tax services to the company or its executive officers of the type that would impair the auditor's independence under the PCAOB's proposal on ethics and tax services? Do any of the services involve tax shelters?
- Has the company experienced any significant changes in the relationship with the external auditors under the new system of PCAOB oversight?
- When will the lead partner and concurring partner rotate off the company's audit? Do the replacements have adequate expertise? Has the audit committee reviewed their credentials?
- Do the external auditors provide non-audit services to the company? What is the nature of these services, and how much has been incurred in fees? Does the company plan on using the external auditors for non-audit services in the future?
- What criteria does the audit committee use in deciding whether to pre-approve nonaudit services?
- Were there any disagreements with the external auditors that arose during the year or were issues discussed with them that relate to management's integrity? If so, what were they? Were they brought to the attention of the board of directors or audit committee, and how were they resolved?
- 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?

### Shareholder Questions (continued)

- Did the external auditors review the “pro forma” disclosures in the company’s recent press releases?
- Does the company use outside accountants other than the external auditors for non-audit services? If so, what did these services involve? Were the external auditors informed if other outside accountants were consulted on issues that might affect the company’s accounting or financial reporting?
- Why do firms other than the principal auditing firm audit certain subsidiaries, divisions, or segments? Does the principal auditor take responsibility for the audit work performed by others?
- How significant are the fees paid by the company to the external auditors in relation to the total revenues of the external auditor?

### Other

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

### Understanding The Financial Statements

Shareholders may have questions about the effects of accounting changes that took effect in 2004 as well as those expected in 2005. The biggest changes affect accounting for share-based payment and aggressive or uncertain tax positions.

Questions may also arise about a new form of financial reporting known as XBRL, which is permitted by the SEC starting with 2004 financial reports.

#### Share-Based Payment

The FASB issued Statement No. 123R, *Share-Based Payment*, in 2004. Although companies were not required to adopt the standard for their 2004 financial statements, they were permitted to early adopt it, and the media reported that a number of companies were reconsidering their compensation strategies in anticipation of the required adoption date.

Statement 123R changes the accounting for transactions in which a company receives employee services in exchange for (a) equity instruments of the enterprise or (b) liabilities that are based on the fair value of the enterprise's equity instruments or that may be settled by the issuance of such equity instruments. The major change in accounting introduced by Statement 123R is that the statement generally requires that these transactions be expensed using a fair-value-based method.

Among the enhancements or alternatives to stock options that companies have considered are restricted stock, performance plans, and cashless exercise features.

The technique of accelerated vesting has been publicized in the media as a way to deal with underwater options prior to the adoption of Statement 123R. The SEC staff has said that companies need to adequately disclose their rationale for executing this strategy in anticipation of the adoption of Statement 123R, and the disclosures should be detailed and robust.

#### Uncertain Tax Positions

Shareholders may be concerned about the company's use of aggressive tax positions, especially in view of a FASB proposal expected in the summer of 2005.

The FASB is expected to propose that tax benefits be recognized in the financial statements when they are probable of being sustained by the taxing authorities. Derecognition would occur when it is more likely than not that the position will not be sustained.

Under the FASB's tentative conclusions, companies would be required to disclose any tax position that was taken in the company's tax return but is not probable of realization. In making these disclosures, companies would have to assume the return will be audited by the IRS, meaning they will be precluded from factoring into their calculations the possibility the exposure may go undetected. Investors may

be concerned that this accounting treatment will amount to a road-map for the IRS or that it will entail additional costs to support the company's position, for example, costs of transfer pricing studies or opinion letters from lawyers.

#### XBRL Reporting

XBRL is an information standard that harnesses the power of computers to help users extract consistent and comparable information from electronic statements. The SEC permitted companies to file XBRL data starting with their 2004 financial statements. Potential benefits include faster, more accurate financial analysis and less costly, higher quality controls.

## Shareholder Questions

### Quality of financial reporting

- What controls does the company have over complex accounting transactions?
- Were there any changes in senior-level personnel in the company's accounting function? What were the reasons for the changes?
- What is the company doing to improve its annual report and make it more understandable to shareholders?
- Is the company clearly and accurately disclosing the compensation, benefits, and perquisites of executives?
- Has the company selected appropriate accounting policies? Why does management use a particular accounting method (e.g., revenue recognition, amortization method, and cost deferral) in light of different policies used by the company's competitors? Has the company consistently and properly applied the appropriate accounting policies? Are the company's overall accounting policies aggressive or conservative?
- 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?
- Has the company been required to restate earnings?
- Did the company consult with the SEC regarding any accounting matters during the past year?
- How does management assess the significant operating, market, and credit risks that are discussed in the annual report?
- Why does the company file financial reports with the SEC on Form 10-KSB (which requires only a balance sheet for the current year and income statements, statements of comprehensive income, and cash flow statements for the most recent two years) rather than on Form 10-K (which requires balance sheets for the last two years and income statements, statements of comprehensive income, and cash flow statements for the last three years)?
- Were any accounting policies or estimates changed this year? To what extent are estimates by management part of the financial reporting process? Which estimates are considered critical? How does management determine when and if a change in estimate is appropriate?
- Why did the company change its method of accounting for \_\_\_? Why is this method better than the former one? Did the external auditors provide the company with a preferability letter?
- 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?

### Recent accounting changes

- Has the company re-evaluated its method for valuing share-based payments? Are effective systems of internal control in place over accounting for share-based payments?
- How will the adoption of FASB Statement 123R affect the company's earnings?
- Has the company determined the impact of the Medicare Drug Subsidy?
- What is the funded status of the company's pension plans? What does the company intend to do about any over-funded or underfunded plans? Has management considered any changes to those pension plans?
- What is the assumed long-term rate of return on pension plan assets for accounting purposes? How did management (and the audit committee and the auditors) conclude that the assumed long-term rate of return is a realistic long-term expectation?
- Does the company have any variable interest entities (VIEs) or special purpose entities (SPEs), or other "off-balance sheet financing" arrangements? What transactions does the company enter into with VIEs or SPEs and why? Are the SPEs consolidated? Are there any related parties involved with any such entities or arrangements? How did the company determine that it did not need to consolidate any such special purpose entity?
- Is the company using special purpose entities for its real estate assets?
- Did the company provide any financial guarantees? What impact did the issuance of FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*, have on the company?
- What were the major costs included in the company's restructuring charge? When is the plan expected to be completed? What are the estimated efficiencies and savings expected in future periods? Have the estimated efficiencies and savings from the restructuring been compared to actual results? What was the impact on the company's restructuring accrual due to the issuance of FASB Statement 146? What impact will Statement 146 have on restructurings in the future?

### Shareholder Questions (continued)

- 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?

### Uncertain tax positions

- What is the company's accounting policy for uncertain tax positions? How will the FASB's proposal affect the financial statements?
- Is the IRS or any other taxing authority currently examining any of the company's tax returns? Have any changes been proposed? What is the likely outcome of these challenges? What is the company doing to minimize income taxes?
- If the company has had the benefit of utilizing net operating losses, when does the company expect to begin paying taxes or incur a "normalized" tax provision?
- What strategies does the company use to minimize corporate income taxes? Are any of these strategies subject to challenge by the tax authorities? Are the effects of potential income tax disallowances reflected in the financial statements?
- Has the company entered into aggressive tax avoidance or deferral techniques? Who approved those transactions? Would the company do them again?
- Have tax authorities challenged the company's pricing on intercompany transfers between foreign and domestic jurisdictions? What is the likely outcome of that challenge?
- Did the company pay any significant Federal, state, or local tax, or foreign penalties recently? What measures are being taken by management to reduce or eliminate non-deductible interest and tax penalties?
- Does the company have 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?

### 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?

### Shareholder Questions (continued)

- 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 was the company's financial performance affected by the changing value of the dollar in relation to a specific foreign currency?
- Does management anticipate incurring losses from concentrations of credit risk that are discussed in the annual report? What is management doing to reduce credit risk concentrations? Will these actions impact sales and earnings?

### Trends

- Does the company believe its current financial condition is stronger or weaker when compared to one year ago? What factors does management use to assess the company's financial condition? Are management incentives based on financial condition, cash flows, results of operations, or a combination of these factors? If so, why?
- Does the company hold any real estate or other assets that have increased in value but are not reported at fair value in the financial statements? If yes, which assets have increased in value and by how much? Does the company's stock price reflect this fact?
- What are the factors that cause differences between the company's reported earnings and its cash flow from operations? In managing the business, does management rely more on reported earnings or cash flow? What are the most important economic trends that management relies upon in managing the day-to-day business of the company?
- Did sales and earnings meet management expectations in 2004? How are expectations benchmarked?

### Other matters

- Does the company intend to use XBRL reporting?
- Why did the company delay its SEC filing and/or earnings release for its 2004 fiscal year-end?
- Why doesn't the company release earnings earlier?
- Will the company be able meet the accelerated filing dates for SEC filings?
- Why does the price of the company's stock decrease or increase so much in response to relatively small changes between actual and expected earnings? Does this volatility relate to the price-earnings multiple of the company's stock?

### Management's Plans and Strategies

Shareholders typically have questions about management's plans and the company's ability to adapt to the changing economic environment. Following the recent economic rebound, studies show many companies have more cash on hand and available for mergers and acquisitions (M&A). The American Jobs Creation Act (AJCA), a major tax law enacted in 2004, may increase cash reserves still further and also help create American jobs. As a result, the key issues at 2005 annual meetings are likely to involve M&A, as well as other uses of cash, and the company's response to the AJCA.

Shareholders may also question the effects on the company's future growth of unintended consequences resulting from efforts to comply with the Section 404 internal control reporting requirements. Other areas of concern this year may include the company's risk management policies and practices in the wake of high-profile investigations of insurance transactions.

#### Mergers and Acquisitions

As business combinations have come back into corporate plans, shareholder activists have grown concerned about fairness opinions and change-in-control provisions included in proxy statements. Fairness opinions are often issued by the same investment banks that offer advice on the business combination. Essentially, the letter represents an opinion that the consideration to be paid or received in a transaction falls within a range of fair values for the company being sold or acquired.

Some shareholder activists have grown concerned about the inherent potential for a conflict of interests because the banks get most of their fees for their advice after the deal is done, with the result that the

banks have a strong incentive to say the price is fair so the transaction will succeed

In response, the NASD released proposed rule changes in 2004 that would require more disclosure of significant conflicts of interest by investment banks, along with the steps the firms are taking to counteract those conflicts. The NASD is expected to issue new rules for fairness opinions soon, possibly together with the SEC.

Proxy advisors have been less concerned about fairness opinions. But they are cautioning shareholders about change-in-control provisions that involve payments to executives. The concern is that these payments could represent excessive compensation and they provide a way of avoiding issues normally dealt with in compensation-related shareholder proposals.

In effect, the change in control provisions amount to disguised "poison pills." Shareholders are faced with a choice between voting against an otherwise attractive merger or ratifying by implication compensation that appears excessive.

Companies that don't plan to use excess cash reserves for M&A may plan to use the funds to buy back company stock or increase dividends to shareholders. While this would seem to be welcome news to investors, it also raises questions about why the company is not reinvesting the cash in its future growth.

#### Unintended S-OX Consequences

Section 404 of the Sarbanes-Oxley Act requires that companies and auditors report on internal controls. Shareholders may be concerned about reports of companies postponing investments in business combinations or information technology to avoid risking any change in controls that might alter their 404 reporting or readiness.

#### Response to Tax Incentives

The AJCA provides a number of tax incentives, including a one-time exclusion from taxable income for 85 percent of repatriated foreign earnings. In effect, this allows companies to bring back to the U.S. foreign earnings at a reduced 5.25 percent rate of tax.

In view of the tax incentives provided by the Act, shareholders may want to know if the company is taking maximum advantage of the tax relief provided by the Act. They may also want to know how any repatriated funds will be used.

#### Risk Management Practices

During 2004, a number of criticisms and concerns cast a spotlight on insurance practices. As a result, shareholders may want to know if

management is reconsidering the relative merits of various forms of risk management, such as self-insurance, contracts with insurance companies, and captive insurance subsidiaries.

The criticisms and concerns involved rating agency reports that criticized the financial reporting practices for

finite-risk reinsurance on the grounds that these policies do not transfer or manage risk. Instead, the policies may be used to smooth earnings or they may act as disguised loans when the premium paid for the coverage amounts to a deposit or loan.

While many of the buyers of finite risk policies were insurance compa-

nies, some policies were purchased by non-insurance companies as well, making this an area of concern for shareholders of companies in all industries.

## Shareholder Questions

### Mergers and acquisitions

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

### Dividends, investments, and other uses of cash

- What are management's plans for the proceeds from the recent issuance of its stock or debt, or from the sale of Subsidiary X, patents, trademarks, or tangible assets such as plant, equipment, or real estate?
- If the company has excess cash reserves, does it plan to buy back corporate stock or increase dividends?
- Does the company have an investment committee charged with making recommendations for employing excess working capital? What policies are in place to guide these investment decisions?
- If the company has reduced dividends, why were dividend reductions made without first reducing other cash outlays, including executive compensation?
- How does the company's dividend policy compare to the industry? Has the company considered declaring a stock split or stock dividend? Would a stock split or stock dividend have a positive effect on long-term shareholder value?
- Has the company considered adopting a dividend reinvestment program?
- What is the expected level of investment in research and development (R&D) in the next few years? Has the company benchmarked its R&D spending against competitors?
- How are investment returns on potential new capital projects assessed?
- What was the nature of R&D costs for each of the last three years? Does the company spend more or less (as a percentage of sales) on R&D than its competitors? What new products were introduced in 2004 as a result of R&D efforts? Were any R&D projects abandoned? If so, what were their costs?
- What is the amount of the company's capital budget for next year and the following year? Are cash flows from operations sufficient for these needs? If not, how will these requirements be financed?

### Shareholder Questions (continued)

#### Response to changes in tax laws

- Does the company expect to create jobs this year or in the near future as a result of the American Jobs Creation Act (AJCA)?
- Has the company revised its nonqualified deferred compensation plans to comply with the AJCA?
- Does the company have a board-approved plan to claim the tax break on repatriated earnings under the AJCA?
- Are there any other new or contemplated tax law changes that had an effect on the company in 2004 or will have an effect in future periods? (Consider Federal, foreign, and state laws.) Will the company consider increasing or decreasing asset allocations as a result of tax law changes in foreign or domestic jurisdictions?
- How does management assess whether tax-planning strategies are effective in managing its income tax obligations domestically and on a worldwide basis?

#### Response to changes in economic or political environment

- What effect does the state of the economy or political environment in the U.S. or in other countries have on the company? Does the company expect any benefits or difficulties as a consequence of these conditions?
- How did domestic and international economies affect 2004 operations? What would be the impact on 2005 profits if additional foreign economies experience difficulties this year?
- Who are the company's major foreign competitors? Does the company have plans to address increased foreign competition? What are they?
- If U.S. interest or inflation rates rise, how will that affect the company? How will increases in the price of oil and other commodities affect the company?
- How have the company's financial results been affected by the war in Iraq? What steps has the company taken to protect its personnel and facilities from terrorism and war?
- What is the likelihood that a foreign government will nationalize the company's operations?
- Which foreign countries, if any, restrict or prohibit the repatriation of earnings or assets?
- How does the company plan to take advantage of the bankruptcy of Competitor Y? Why did the competitor fail, and what measures is the company taking to ensure that a similar fate is not in store for itself?
- Does the company rely heavily on imports or exports, or compete with foreign companies? If so, how will the changing value of the dollar or the current political environment affect the company's competitive position? What measures are being taken to reduce the possibility of loss from foreign currency exchange rate changes?
- Is the company susceptible to exposures arising from market risks and concentrations (e. g., major customers, products, geographical)? How does the company address these risks?

#### Prospects for growth and expansion

- What are the major strategic and operating problems facing the company now and in the next five years? How does management plan to address these issues?
- Have any new competitors entered the company's markets? How has the new competition affected the company's strategic planning? How did the company react to additional competition?
- How have new products been received in the marketplace? What 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?
- Are any of the company's products subject to government regulation? Does the company have any significant new products awaiting government approval? What is the expected approval date?
- What percentage of the company's sales is from government contracts? Are any of these contracts subject to renegotiation? When do such contracts expire?
- Are the benefits or useful lives of any products questionable due to competition, patent challenges or expiration or other factors?
- 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 does the company maintain the quality of its products? What quality assurance procedures are currently in use? Are additional quality assurance procedures being considered?

### Shareholder Questions (continued)

- Does the company take steps to elicit feedback from customers on the level and extent of customer satisfaction?
- Are research and development capabilities or other intangibles critical to the company's competitive strategy? If so, which ones and what steps is the company taking to protect or enhance these intangibles?
- Has the company formulated a plan to protect against the unauthorized use of trade secrets, know-how, and other information by former key employees?
- Does the company have any significant sales or purchase commitments for commodities that are vital to sustain critical operations? Are financial derivative contracts, such as futures contracts, used to ensure a steady supply or constant price for these items?
- Why does the company rely exclusively on a particular customer or supplier, or on a relatively small number of customers or suppliers? Could this relationship adversely affect shareholder value?
- Does the company 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?
- 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 2004? What are advertising expenditures expected to be in 2005? What factors are considered in determining if advertising is effective?

### Workforce and management succession

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

### Technological and financial innovation

- Has the company delayed any investments in technology due to Sarbanes-Oxley requirements?
- Is the company making the best use of its computer system? Could any accounting operations, presently performed manually, be computerized? Could the costs of its information systems be reduced?
- Is management up to date on information technology changes and does it regularly evaluate the possibility of implementation of new technologies where warranted?
- How is the company making use of technology in its manufacturing operations? How is management addressing employee, union, and community concerns about jobs being eliminated through plant automation?
- Does the company sell its products or services over the Internet? If not, does the company plan to establish Internet commerce?
- What precautions are being taken to ensure that information transmitted through the Internet does not fall into the wrong hands or become compromised? Does the company have a privacy policy regarding customer and employee information?
- What new financial products are being offered to customers? Are these products being marketed by competitors? Is the company a participant in any of these transactions? If yes, what is the maximum exposure to the company if the financial products fail to perform as intended?

### Cost-cutting and restructuring programs

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

### Shareholder Questions (continued)

- Does the company plan to offer early retirement or other termination incentives to employees to reduce costs and overhead expenses?
- What is the company doing to control employee benefit costs?
- What amount was incurred by the company for health care costs for its workforce last year and last quarter? What steps are being taken to control these costs? Has the company considered self-insurance to better manage these costs? Why does the company provide or not provide health insurance for retirees? Does the company believe it would incur significant cost increases if legislation were passed that regulated managed-care providers?
- What plans are in place to assist displaced workers? What is the labor union's position on this issue?
- Has the company outsourced any of its data processing, manufacturing, or other operations? If not, has this been considered and how were the risks of this action assessed? How much of its operations did the company move to offshore locations? Were the overall economic consequences considered?
- Is there any idle production capacity? If so, what actions are being considered to eliminate it?
- How is the company controlling its energy costs in the current operating environment?

### Risk Management

- What risk management techniques are used to evaluate the adequacy and cost effectiveness of insured risks? What is the limit of the company's product liability and catastrophic loss coverage?
- Does the company self-insure any risks? How sensitive are earnings to changes in assumptions about self-insurance?
- Does the company have a risk assessment committee?
- What guidance has the board of directors given management in developing a risk management system?
- What oversight role does the board of directors have to ensure the integrity of the company's risk management system?
- Has the company purchased or sold any finite-risk insurance products?
- Is the company considering any changes in its insurance practices?
- Has the company had difficulty obtaining terrorist insurance? Or any other type of insurance?
- Is there a proper separation of duties between those who create financial risks and those who manage and control those risks?
- Does the company use enterprise risk management?
- What is the company's attitude towards financial risks?
- Were there any significant foreign currency exchange gains or losses in 2004 and in interim 2005 operations? What is the company doing to minimize the impact of changes in foreign currency rates? Does the company hedge its foreign currency exposures?
- What types of financial instruments and derivatives does the company use?
- How are the company's financial instruments and derivatives valued?
- Does the board of directors understand the implications of the company's financial instruments, specifically derivatives (e.g., options, futures, forwards, caps, collars, interest rate swaps)?
- Does the company have written guidelines and policies on the use of financial instruments and derivative instruments? Who formulated those policies? Did the board of directors approve those policies?
- Is there a limit system in place (i.e., a system that sets the maximum amount of loss the company would tolerate before liquidating a position)?
- What are the major risks from the company's use of financial instruments or derivatives?
- Do management and the board of directors monitor the company's financial instruments and derivatives exposures?
- Does the company plan to change its use of derivatives, co-cos, synthetic leases or other financial instruments?
- How does the company monitor the retirement plans' investment performance? Do the external auditors audit the plans' financial statements? Who sets the investment policy for the plans' assets?
- What additional costs were incurred as a result of the events of September 11, 2001? Has the company had to implement additional security measures?

### Capital structure

- What is the company's current price-earnings ratio? Why is it so high or low compared to competitors? In light of this, why has or hasn't the company issued additional common stock to meet its business expansion plans?

### Shareholder Questions (continued)

- 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?
- Has the company considered any revisions to common stock voting rights? Has the company considered issuing other classes of common stock with rights and privileges different from those accorded to the company's common stock? What would be the benefits of such a class of stock?
- How do FASB Statement 150 and the FASB's project on liabilities and equity affect the company's capital structure? (See our Financial Reporting newsletter, *FASB Statement No. 150 Brings Big Changes* (July 2003), at <http://www.bdo.com> for a summary of possible changes.)
- Has the company violated (or approached violating) any loan covenants? If so, what costs were incurred to obtain waivers or to restructure these debts? Are additional violations expected in the near term?
- Has the company considered adopting or rescinding an employee stock purchase plan?

### Sources of financing

- How has the outlook for the stock market and bond market affected the company's plans for a public offering of its stock or debt? What industry or company factors are relevant in creating a favorable environment for raising additional equity or issuing debt? Does the company plan to refinance any of its existing debt?
- Would the company consider obtaining additional financing from a private placement of its common stock or debt to institutional investors? Why or why not? Would institutional investors receive more favorable terms in comparison to the terms that might be negotiated with other third parties?
- Is the company considering any divestitures? If the company is considering any M&A transactions in order to reduce risks attributable to its current operating concentrations, how would they be financed?
- Would the company pay a market premium if it were able to purchase large blocks of shares from institutional investors? How would this affect the share price?
- Why does the company issue options, warrants, and convertible securities if such securities have the potential to dilute the interests of current shareholders? How do these actions increase shareholder value?

### Liquidity and debt

- What is the company's bond rating? Why was the company's credit rating changed, and what impact will this have on future borrowings? Did the company anticipate this change? What steps are planned to improve the ratings?
- Is it possible that the company will restructure its debt or file for bankruptcy protection? What effect would this have on existing shareholders, creditors, employees, and the communities in which the company operates?
- Have transactions such as asset sales and sale-leasebacks been considered to satisfy liquidity needs?
- How will liquidity of the company be affected by restrictions placed on Subsidiary X, which prevent it from paying dividends to the parent company?
- Will any pending litigation affect the company's liquidity needs? How does management assess the potential economic impact of litigation in deciding what course of action it will take?
- Why did the company incur a deemed dividend or unusual financing charge as a result of beneficial conversion terms on convertible preferred stock or debt? Why did the company offer below-market conversion terms?

### Corporate Codes of Conduct and Business Ethics

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

#### Concerns About Codes

The New York Stock Exchange rules that took effect in 2004 require that listed companies adopt and disclose a code of business conduct and ethics for directors, officers, and employees. Under the NYSE’s rules, these codes must address certain key areas and their availability to shareholders, either on the company’s website or in print, and the codes must be referenced in the company’s annual report filed with the SEC.

Shareholders care about these codes because a good code of conduct can carry a lot of weight if a company is ever accused a serious wrongdoing.

For example, some corporate codes are designed to address the factors that the SEC considers when deciding whether or not to take enforcement action against a company it is investigating for financial statement irregularities.

The SEC outlined four broad types of factors in a 2001 Report of Investigation and Statement. Together, these factors provide a framework for assessing the extent of company’s cooperation when targeted

for an investigation or enforcement action.

Similar measures are incorporated into the U.S. federal sentencing guidelines under which a company should receive a reduced fine, if the judge finds the company had an effective compliance program. These guidelines were amended in 2004 to add that a company’s corporate directors and officers should be knowledgeable about the company’s compliance and ethics programs.

#### Focus on Business Ethics

Whether mandatory or advisory for judges, companies can find corporate compliance programs difficult to enforce in emerging market economies. In 2004, the U.S. Department of Commerce together with the International Trade Administration, issued a 355-page report entitled *A Manual for Managing A Responsible Business Enterprise in Emerging Market Economies*.

The Commerce Department’s manual combines codes of conduct and compliance programs with the concept of social responsibility by stressing broad concepts of responsible business conduct, responsible business enterprises, and business ethics programs.

### Social Responsibilities

The key concerns about social responsibilities continue to focus on human rights issues, such as non-discrimination, forced labor, and child labor, as well as environmental concerns.

This year’s key environmental concerns include global warming. In early 2005, as part of an organized letter-writing campaign, 143 institutional investors urged the world’s largest 500 companies to disclose information on their industrial emissions. Some shareholder activists go a step further and ask that the company take steps to mitigate global warming risks, e.g., by reducing greenhouse gas emissions.

Companies in the petroleum, energy and automobile industries should also be prepared for requests for feasibility studies on the potential risks and opportunities associated with investments in renewable energy sources, such as solar energy and energy from hydropower turbines, biofuels, or advanced technologies for geothermal power generation. Shareholders may ask if the company plans to make such investments.

Companies with international operations should be prepared for requests to report on the risks associated with outsourcing or offshoring, as well as the extent to which their operations are exposed to risks of HIV/AIDS infections. Companies that derive more than two percent of gross revenues from operations in regions with a higher HIV/AIDS prevalence rate than the global average are reportedly targets of shareholder activism in this regard.

## Shareholder Questions

### 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?
- Have the company's ethics and compliance programs been updated to comply with the requirements of the Sarbanes-Oxley Act, the revised sentencing guidelines, and any applicable exchange listing rules?
- Do the company's codes of ethics and corporate conduct cover its entire global operations?
- Has the company considered how the actions of "outsiders" such as agents, suppliers, and distributors, reflect upon their ethics and compliance programs?
- Is there a system in place that allows employees to raise ethics and compliance issues without fear of retribution?
- Is there a process in place that allows management and the board of directors to address issues that arise from any level of the organization?
- Is the company's reward system (promotions, bonuses, and salary increases) aligned with the objectives of the ethics and compliance programs?
- Does the company regularly and systematically scrutinize the causes of compliance failures and respond appropriately?
- If any amendments or waivers were disclosed on Form 8-K during the year, can you provide more details about the reasons for them?

### Environmentally Responsible Business Ethics

- Does the company issue (or is it planning to issue) a sustainability report? If not, why not?
- What is the company doing to reduce greenhouse emissions or otherwise prevent or mitigate climate control risks?
- Is the company investing in (or does it plan to invest in) renewable energy sources?
- 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?

### Socially Responsible Business Ethics

- Is the company outsourcing jobs to offshore locations, making it harder for U.S. citizens to find employment? If so, what are the risks?
- How much of the company's revenues come from parts of the world with high HIV/AIDS prevalence rates?
- 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?

### Shareholder Questions (continued)

- 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?

## Shareholder Communications and Investor Relations

Shareholder questions are expanding beyond the boundaries of annual meetings and receiving more attention during the year due to a number of powerful new developments, including SEC rule changes, stock exchange listing requirements, and “best practices” identified in special reports by trade groups. All these changes address a growing sense of frustration among shareholders who feel their views are not welcome or heard in boardrooms by their elected representatives.

### Responsibility

Companies typically assign the responsibility for responding to shareholder questions and processing shareholder communications to an individual or group of individuals in management, such as a separate investor relations group or to the corporate secretary, chief financial officer, or chief counsel.

In the past, the directors’ responsibility for shareholder questions was limited. Some companies may not have required directors to attend the annual meeting, or let them respond to shareholder questions. Instead, the vehicle most often used for expressing shareholder dissent was the shareholder resolution submitted by labor unions, social groups, corporate gadflies and others as part of the annual proxy process.

Today, there is a subtle but growing trend toward resolving differences through more frequent and constructive dialogue between shareholders and directors, thanks in part to recent SEC rule changes.

### Rule Changes

An SEC rule on “Communications Between Security Holders and

Boards of Directors” that took effect in 2004 requires that companies either establish processes for shareholders to send communications to board members, or explain why they have not done so.

Recent revisions to NYSE listing standards require that companies disclose a method for interested parties, including shareholders, to communicate directly with either the presiding director of the board’s executive sessions of non-management directors or with the non-management directors as a group. Even if a company is not listed on the NYSE, its shareholders may consider this a best practice and question why a company does not meet this standard.

### Reports of Best Practices

Other emerging best practices can be found in a report issued by the National Association of Corporate Directors and the Council of Institutional Investors.

These two organizations formed a task force to study best practices in and impediments to more open communications between shareholders and directors. Their report, *Framework and Tools for Improving Board-Shareholder Communications*, is

designed to build on the regulatory initiatives by offering practical suggestions.

The suggested best practices:

- The starting point for board-shareholder communications is an ongoing communications program.
- Boards should provide detailed contact information for the appropriate management representative and at least one independent director.
- Boards should develop and disclose communications policies covering all forms of communication, including in-person meetings, telephone calls, e-mail, and other written communications.
- Boards should agree on which issues are appropriate for them to address and which are appropriate for management.
- Boards should take an active role in ensuring that communications efforts and policies are up to date and effective.

### Reg FD and Earnings Guidance

In developing the kinds of policies suggested as best practices, companies will need to keep in mind the SEC’s Regulation Fair Disclosure, (Regulation FD), which prohibits selective disclosure of material non-public information to one investor or selected groups of investors. This rule has proved frustrating to companies that are tracked by securities analysts and/or release earnings guidance.

## Financial Reporting

Research shows the percentage of large companies that release earnings guidance has dropped from 72 percent in 2003 to 55 percent in 2004, a matter of concern to securities analysts, shareholders who rely on the reports of these analysts, and others who see it as an impairment of rights under the first amendment.

In response to concerns about the unintended consequences of Regulation FD and other matters, the National Investor Relations Institute and the CFA Centre for Financial Market Integrity released a report on *Best Practice Guidelines Governing Analyst/Corporate Issuer Relations*.

In addition to spelling out rules of conduct for securities analysts, the report suggests a series of best

practices that involve the establishment and disclosure of corporate policies setting forth how the company will respond to requests for access to knowledgeable company officials and other qualified persons, including analysts and investors. The report suggests these policies should specifically address one-on-one meetings and industry conferences.

The report also suggests guidelines for the types of information that companies should disclose, depending on whether they choose to provide or not provide earnings guidance.

- Companies that provide guidance should supply the components of earnings (revenues, expenses, gains, losses, mar-

gins, earnings per share, etc.), as well as a sensitivity analysis.

- Companies that don't provide earnings guidance should (1) provide and discuss five-year growth rate projections to ensure a long-term focus, (2) discuss the issuer's business cycle and relevance to the current quarter, pointing out any obvious omission of fact, and (3) discuss each quarter's contribution to the company's long-term strategy.

Shareholders of companies that are followed by securities analysts may raise questions about the company's policies and the extent to which the policies meet the best practices described in the report.

## Shareholder Questions

### Shareholder Communications

- Does the company provide a process for investors to communicate with directors? If not, why not?
- Who in management is responsible for processing shareholder communications and responding to shareholder questions?
- Has the company designated at least one independent director whom shareholders can contact?
- Has the board developed and disclosed communications policies covering all forms of communications, including in-person meetings, telephone calls, e-mail and other written communications?
- What types of shareholder questions are handled by directors rather than management?
- Does the board take an active role in ensuring that shareholder communications efforts and policies are up to date and effective?
- Does the company maintain a Web site that provides helpful information to investors?
- Were any proposals submitted to management for inclusion in the proxy statement that management decided not to include? Why were certain issues omitted from the proxy? Why doesn't the company permit confidential voting by shareholders with an outside party tabulating the results?
- Can a summary of significant matters discussed at the annual meeting be distributed to shareholders?
- 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?
- 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?
- 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?
- What is the total number of shareholders? Who are the principal shareholders?
- How many institutional investors own shares in the company, and what percentage of the total shares outstanding are owned by institutions? What are management's reasons for rejecting any suggestions made by these institutions?

## Shareholder Questions (continued)

### Reg FD, earnings guidance and relations with analysts

- Has the company established and disclosed corporate policies for responding to requests for access to knowledgeable company officials and other qualified persons, including securities analysts and investors?
- Does the company maintain frequent contact with analysts who follow the company? Which analysts are recommending the company's stock? Do they have investments in the company? Have there been instances of unusual trading volume in the company's stock? What caused this?
- How has the company's practice regarding earnings guidance changed in recent years? Why? Will the company continue to provide earnings guidance to analysts?
- Does the company publish earnings forecasts? If so, do the forecasts include the components of earnings (revenues, expenses, gains, losses, margins, earnings per share, etc.)? Do the forecasts include a sensitivity analysis? What factors are used to derive these forecasts? Are these intentionally conservative?
- Does management expect any increase in the volatility of the company's stock price due to changes in earnings guidance?
- Why doesn't the company provide more information about its expected earnings?
- Does management agree with analysts' expectations for earnings in the next quarter and for 2005 earnings? If there are disagreements, how are they communicated to analysts and investors?
- If it is necessary to revise earnings forecasts, how will this information be communicated to the public?
- How does the company ensure that changes in earnings forecasts are communicated in a manner that prevents insiders from benefiting from advance warnings?

### Trends and competitive analysis

- If the company does not provide earnings guidance, has it provided sufficient information about trends and competitive analysis?
- Has the company provided five-year growth rate projections?
- What are management's plans for maximizing shareholder value in 2005 and beyond?
- 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 operating results and financial ratios compare with those of its competitors?
- How do the company's product quality and productivity goals compare to those of its competitors?
- How does the company 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?
- 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 does the company's business cycle affect the current quarter's performance?
- How does the current quarter's performance contribute to the company's long-term strategy?
- How do first quarter earnings compare to the earnings that were projected for the period? What estimates are the most significant in formulating realistic earnings expectations?
- 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?
- Are any changes in accounting methods contemplated? Will the transition allow shareholders to obtain meaningful comparisons to earnings reported in prior years?

## Shareholder Questions – 2005

*A Financial Reporting letter*



### For More Information

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 or to discuss the implications of the matters discussed in this *Financial Reporting* letter, please contact the engagement partner serving you or one of the following partners: Ben Neuhausen or Wayne Kolins.

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