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2005: THE ERA OF CORPORATE REFORMATION CONTINUES

As we turn the pages of the calendar, for most public companies December 31 marked the close of official business; year-end financial results will soon be disclosed. The corporation's most important report card will then be presented to investors and potential owners (with thousands of companies reporting in a narrow time frame). Employees will also be able to clearly understand the state of the business — especially if they read the CEO's Management Discussion and Analysis (MD&A) and other key materials in the Annual Report and 10-K filings.

On the other hand, the meandering course of a trend is more difficult to follow, particularly in an era characterized by dramatic events that do not begin or end in a neatly calendarized fashion. Take, for example, the dramatic events of the past four years, beginning with the downward plunge of the equities market in spring 2000 (when the "Tech Wreck" occurred at NASDAQ) and continuing through the November 2004 implementation of the complex and costly Section 404 of the Sarbanes-Oxley Act of 2002 (SOX). This is surely an era in American business affairs destined for the history books.

Some—including this writer—have called this period the "Era of Corporate Reformation." Question: When does this era end—when do we stop making history and settle down to business? Answer: Don't count on the era ending in 2005!

Consider the dramatic changes occurring in this era of reformation: the bursting of the market's overheated bubble market beginning in spring 2000; the sweeping economic effects of the September 11,2001, terrorist attacks; the Enron and WorldCom scandals; the passage of sweeping legislation, including SOX; the issuance of new listed-company rules by NYSE and NASDAQ; and the pressure of other reforms brought to bear on corporate America and Wall Street.

We have frequently heard that the events of this era resembled the Crash of 1929, that the "Wonderful Era of Nonsense" (as named by era sportswriter Grantland Rice) of the 1920s preceding the crash was similar to the boom years of the 1990s, including a downturn that, for many, resembled the serious economic depression that lasted through the 1930s. We noted that, on passage, SOX was compared to the 1933 and 1934 securities legislation (in fact, the 2002 act greatly expanded these 70-year-old laws).

What reformation events will be writ large for corporate finance managers in the new year? What new or continuing challenges could CEOs, board chairs and members, senior managers, and professionals and specialists such as legal counsel, investor relations officers, and others in positions of responsibility, face in 2005? We present here five major trends that could pose real or potential challenges for finance managers.

More rules for finance managers

Two years after passage of SOX, its effects on corporations and the capital market continued to broaden and deepen. For example, November 2004 was the deadline for corporate implementation of the comprehensive Section 404. Large cap companies struggled throughout 2004 to comply with various SOX-mandated financial reporting practices, accounting changes, and the implementation of sweeping and complex internal controls.

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According to several industry surveys, most U.S. companies were still not prepared for full compliance, despite almost two years of preparation and investment of an average of about $5 million, primarily in internal control systems (with an additional investment of tens of thousands of man-hours for full compliance).

Section 404 compliance in 2005 means that the majority of companies reporting on a calendar-year basis will have to formally assess — and their senior executives attest to — the effectiveness of their internal controls over financial reporting. Keep in mind that outside auditors — now under the direct purview of the SOX-created Public Company Accounting Oversight Board (PCAOB) — will also have to provide an independent opinion on the effectiveness of controls and certify their findings. (There could well be disagreements between corporate management and auditing team in the process.)

Under SOX, severe personal penalties — including forfeiture of personal funds and criminal prosecution — can now be pursued in courts of law by federal prosecutors for the certification of fraudulent statements by corporate executives. The Bush Administration has a multiagency anti-fraud team organized for just this purpose, under the number two Department of Justice official, James Comey, who formerly led white-collar criminal prosecutions in New York City.

The effective date of the complex Section 404 was delayed throughout 2004, and, as the compliance deadline neared, PricewaterhouseCoopers Chair Dennis Nally announced that his firm's survey found most companies were not ready — perhaps 20 percent were on schedule — for early 2005 compliance. The key questions for 2005: If a company lags in compliance and is unable to certify, will financial analysts take Section 404 noncompliance into account? Will individual investors care? Will it matter if literally *hundreds* of public companies remain out of full compliance for some period in the new year?

Adoption of COSO's ERM framework

Looking beyond the significant challenges related to achieving full compliance with Section 404, the integrated framework for enterprise risk management authored by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)[1] will also be more widely adopted in 2005. Companies that ignore this trend could be asked "why" by investors.

COSO retained PricewaterhouseCoopers to develop the new framework, noting that "until now, there hasn't been a comprehensive framework that truly meets the far-reaching demands of the new regulatory and competitive environment." The framework, made public in fall 2004, provides boards and senior managers with a powerful roadmap for identifying risks, avoiding pitfalls, and seizing opportunities to grow value. The new model is built on the foundation of COSO's earlier *Internal Control—Integrated Framework,* which public companies now use to comply with SOX requirements.[2] The internal control framework consists of five components: control environment; risk assessment; control activities; information and communication; and monitoring. The Securities and Exchange Commission (SEC) is encouraging companies to look to the COSO models for guidance.

Corporate pension overhang on 2005 earnings

At mid-year 2004 the news headlines began: the federal agency insuring corporate defined benefit pension plans, the Pension Benefit Guaranty Corporation (PBGC), was running annual deficits and accruing potential (and future) liabilities in the hundreds of millions of dollars (if plans were to fail) as companies consistently underfunded their plans, usually by overestimating return on investment.

There is huge disagreement about what all this means. Corporate managers argue that the market turnaround is increasing the asset base of many pension plans, and that the payout to beneficiaries will take place over a period of years, well into the future, not all at once in the present. On the other hand, the PBGC and members of Congress warn that the failure of companies in the airline industry, like that of the steel and

rubber industries earlier, could seriously erode the base of financial support for retirees, as provided by the PBGC for failed plans. The new Congress is almost certain to devote a great deal of attention to this issue, with perhaps a "Sarbanes-Oxley-type" measure to beef up PBGC finances.

That could mean several developments directly affecting corporate finances in 2005. Corporate insurance premiums could increase dramatically, as was the case after the savings and loan debacle of the 1980s (Congress must address the rate). The PBGC could require managers of underfunded corporate plans to make huge payments into their plans. This has happened before, notably to General Motors in the 1990s, when billions had to be paid in to make up the shortfall.

The pressure is still on General Motors, as it is at Ford Motor Company, most of the airlines, and other companies, industries, and sectors. Late 2004 news accounts had some large companies "technically insolvent" when all pension fund liabilities were totted up and matched against present total market capitalization of the funds. The *New York Times* pages set a tone: "Tens of thousands of Americans are discovering, as they approach retirement, that money they were promised [in defined benefit pension plans] is not forthcoming. This is a national problem." In 2005, corporate defined benefit plans will increasingly become a focus of national attention—by labor unions, employee groups, members of Congress, think tanks, academics, financial analysts, and investment managers (the buy side). For, if corporations are forced to contribute large amounts of money in the short term to their underfunded plans, short-term earnings will certainly be affected. Balance sheets could be distorted by required adjustments.

Though perhaps not as dramatic as shortfalls, potential pressures on pension fund balances also result from social changes currently underway. New York State is moving to recognize same-sex marriages for its pension fund beneficiaries. In late 2004 Comptroller Alan Hevesi—one of corporate America's most powerful institutional shareowners—ruled that the state plan will treat gay couples with Canadian wedding licenses as it treats other married couples, in terms of granting benefits. Could New York State-domiciled corporate plans be required to follow? What if this trend sweeps the pension fund community? What would happen to stressed corporate plans in 2005 if states pressure companies to significantly expand coverage to address emerging social issues? (The California Employees Retirement System (CalPERS), it is worth noting, is set to follow the New York fund's example early in 2005 for state employee beneficiaries.)

CORPORATE DEFINED BENEFIT PLANS WILL INCREASINGLY BECOME A FOCUS OF NATIONAL ATTENTION.

A very long proxy season

It appears that in 2005 "year-round proxy seasons" will begin. The leaders of the year-round activism movement include such activist investors as the faith-based organizations within the Interfaith Center for Corporate Responsibility (ICCR); the $100 billion New York State Common Fund under sole trustee Comptroller Alan Hevesi; New York City's funds under Comptroller William Thompson; and CalPERS. Their colleagues in their various perennial campaigns include trustees and internal managers of public employee pension funds, labor union funds, socially responsible mutual funds, foundations, and endowments.

CalPERS is largest state fund, with assets of $168 billion. In late 2004, CalPERS served notice on corporate America that the fund now has a clear, focused plan to rein in "abusive compensation practices" and will hold individual directors and board compensation committees "more accountable" for their actions regarding egregious practices in overseeing CEO and senior management compensation.

In 2005, CalPERS will apply systematic pressure to the SEC, the financial exchanges, and outside compensation consultants to address issues of transparency and disclosure and especially the design of corporate compensation systems. This is a three-year, six-step campaign. In a carrot-and-stick approach, CalPERS will wage aggressive campaigns against select individual companies—targeting the board compensation committees—where the CalPERS board believes a company demonstrates the worst in compensation practices; the fund will also applaud good behavior by recognizing companies who are leaders in pay-for-performance policies.

CalPERS promised a "focused approach to today's most serious problem," accord-

ing to President Sean Harrigan. A limited number of companies in 10 market sectors will be targeted in 2005 for intense action; CalPERS will also withhold proxy vote support for individual directors. "Compensation can be so obscene that we need to tackle the problem structurally and hold accountable selected individual directors who create and support abuse pay packages. We are calling on institutions and allies to join in the campaign," said Investment Committee Chair Rob Feckner.

Mutual fund disclosure—another ticking time bomb?

Recall that in 2004 the nation's mutual funds were required to make publicly available two important sets of information:

- Their formal corporate governance guidelines for voting the shares in their portfolios at proxy time; and
- The actual votes, company-by-company, for all shares voted.

The mutual fund industry's trade association vigorously opposed this mandate, which had originally been suggested by Amy Domini, head of the socially responsible $1.8 billion Domini Social Fund (Ms. Domini voluntarily disclosed her fund's votes for several years before the SEC responded with its rule).

Conflict of interest is a major concern of the mutual fund advisor community: when an advisor also manages 401(k) and other investment vehicles for corporations, does the fund vote with management (pro forma) or with the shareowner activists? It didn't take long for the 2005 possibilities to emerge.

In November 2004, the AFL-CIO Office of Investment released its "Behind the Curtain" report on how the ten largest mutual fund families voted—"when presented with the opportunity to curb CEO pay abuse"—in 2004.[3] Labor union analysis of the filings provided a preview of the action to come in 2005. When voting on proxy proposals designed to curb CEO "pay abuses," says the AFL-CIO, there is significant variation among mutual fund families. American Century, for example, won a 100 percent approval rating from labor, while Putnam Funds—part of the giant Marsh & McLennan organization and also directly under fire by New York Attorney General Eliot Spitzer in the closing months of 2004—was awarded the lowest mark (at 20 percent). Fidelity, the nation's largest fund complex and therefore one of the largest proxy voters for corporate America, got only a 25 percent score (negative) while the second-largest fund family, Vanguard, was ranked second from the top, with a favorable 75 percent score.

AFL-CIO analysts determined that of the 120 proxy voting decisions examined in its study, 25 decisions involved mutual fund advisors also doing business with companies held in their investment portfolios. Said the union investment managers: "These widespread conflicts of interest not only underline the importance of transparent proxy voting by mutual funds, but also point to the need to [further] enhance the SEC rule to require mutual funds to disclose business relationships with portfolio companies."

This report will be read with great interest by shareowner activists and government reformers, who will no doubt hear the call for "enhancement" of disclosure rules. In some cases, finding a fund's information (usually on the fund's website) can be a challenging hunt for the proverbial needle in a haystack. For corporations seeking to guide resolutions through the proxy process, there could well be significant challenges ahead as mutual funds managers, knowing their votes will be scrutinized by activists, are pressured to vote against management.

The five major trends detailed here are among perhaps a dozen or more "potential events" that could result in important changes in the way corporate finance managers make decisions, implement policies, report corporate financials to stakeholders, and develop additional compliance programs. We will be exploring some of these issues in these pages in the months ahead. Happy New Year! •

NOTES

1 The framework has the imprimatur of the commission sponsors, the American Accounting Association (AAA); the American Institute of Certified Public Accountants (AICPA); the Financial Executives Institute (now Financial Executives International (FED); the Institute of Internal Auditors (IIA); and the National Association of Accountants (now the Institute of Management Accountants (IMA)).

2 The executive summary of *Enterprise Risk Management—Integrated Framework* is available on the COSO website at www.coso.org.

3 The AFL-CIO examined the proposals and votes of companies that included Delphi, Union Pacific, Lucent, PeopleSoft, Sprint, and Bear Stearns. The report is available online at www.aflcio.org/corporateamerica/paywatch/upload/BehindtheCurtain.pdf.