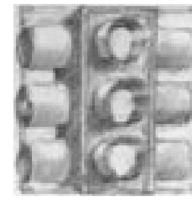
Definitely Maybe

ARIK JOHNSON, *Aurora WDC*



Real-time reporting under Sarbanes-Oxley Section 409 demands a solid CI program supporting risk management and security in numbers.

In a September 30, 2004 press release, pharmaceuticals giant Merck announced a voluntary worldwide withdrawal of Vioxx, its $2.5 billion blockbuster acute pain medicine, from the market. A three-year clinical trial was halted after Merck discovered participants had double the risk of a heart attack compared to those taking a placebo.

While the impact of the press announcement was felt immediately, when the company issued an 8-K to investors announcing the withdrawal the following day, it did so in compliance with new regulatory rules governing accelerated reporting of material events. At the same time, it gave competitors like Pfizer and Novartis cause for concern over how this announcement would affect the prospects of their own competing pain products in the same class.

Merck's stock plunged almost 27 percent, wiping out $28 billion of shareholder market value in one trading day as the company said the recall would hurt earnings. Vioxx is one of Merck's most important drugs, with 2003 global sales of $2.5 billion – 11% of the company's $22.49 billion in revenue. Approximately two million people worldwide use Vioxx for arthritis, acute pain, and disorders such as carpal tunnel syndrome. The specter of layoffs at Merck now also looms as the company is forced to adjust its cost structure to adjust to the loss of a large chunk of its cash flow.

The question now on the minds of Merck's competitors in the COX-2 inhibitor class, specifically Pfizer's Celebrex and Bextra and Novartis' Prexige, is whether this should translate into improved sales or impact prospects for the whole drug class more broadly. So far, the clinical trial results indicates that the coronary risks are isolated to Vioxx alone. Still, Pfizer must wonder if it should issue its own 8-K explaining the implications and impact on its business as its Celebrex arthritis drug dominates the market with about $2.6 billion in US sales last year.

REPORTING MATERIAL EVENTS

So, why all this fuss about that simplest of regulatory forms, the humble 8-K? Because beginning August 23, under Section 409 of Sarbanes-Oxley, SEC-regulated companies now have four business days to report 8-K events that could have a *material effect* on their financial results. (See Sidebar 1.)

Previously, companies had five business days or 15 calendar days under the pre-amendment Section 13 law to issue an 8-K. While the acceleration seems slight, the Securities and Exchange Commission's (SEC) has now broadened regulations to include eight new triggers for 8-K filings in addition to the original 11, and enforces these so-called *real time issuer disclosures* to help govern shareholder oversight. Translation: if you're CFO of a publicly held company that trades on a US exchange, your life just got a lot more complicated.

THE NEED FOR EARLY WARNING

Reporting of material events has raised the stakes for competitive strategy in areas reaching across the whole of an enterprise and its markets. It has also increased the need to support market predictability with robust competitive intelligence tools and techniques for early warning and analysis of potential scenarios that could impact the business.

In my view, the impact of Sarbanes-Oxley 409 on the CI profession goes even deeper than Gartner's Richard DeLotto warned earlier this year. In a brief in *SCIP.online*, his advice was not to make it any easier than it has to be for competitors to gain valuable CI from your company's 8-Ks, while using theirs to maximum effect:

"While the materiality of an event should properly be interpreted by your

SIDEBAR 1: WHAT DOES SECTION 409 SAY?

Section 409 - Real Time Issuer Disclosures

Section 13 of the Securities Exchange Act of 1934, as amended by this Act, is amended by adding at the end the following:

"(l) Real Time Issuer Disclosures. - Each issuer reporting under section 13(a) or 15(d) shall disclose to the public on a rapid and current basis such additional information concerning material changes in the financial condition or operations of the issuer, in plain English, which may include trend and qualitative information and graphic presentations, as the Commission determines, by rule, is necessary or useful for the protection of investors and in the public interest".

legal and financial team experts, CI staff should offer their expertise as to what information might be more valuable to competitors than investors. CI staff should be equally prompt to capture any information put into the public record by competitor's 8K filings." [*SCIP.online*, issue 57, June 7, 2004.]

US LAW WITH GLOBAL TEETH

But this isn't just a headache for US securities. The new rules govern any company floating a bond offering, as well as foreign firms operating in US markets or traded on a US exchange, like Novartis. And the future of competitiveness in small and medium-sized enterprises is at also stake.

In the process of compliance with these new corporate governance regulations, the world's largest companies are also more likely to be made aware of and responsive to the subtlest of changes in the marketplace. This makes 409 perhaps the single highest impact event in promoting robust CI adoption in a generation.

Not only are smaller, unregulated rivals placed at a disadvantage if they fail to rise to a similar level of competitive preparedness, but any sale of holdings on the part of private firms to public ones, (as well as any private firms seeking an initial public offering), will require backward-looking compliance in order to bless the transaction.

DEFINING MATERIAL

Not only must CFOs look at numerous financial events daily and ask "is this a reportable condition?", they must also gain an increased measure of predictability, awareness, and responsiveness to short-notice market changes.

Just deciding what the word *material* means is problematic. In a 1999 staff accounting bulletin, the SEC said an event is material "if there is a substantial likelihood that a reasonable person would consider it important." The commission also curbed the use of *rules of thumb* – such as five percent of net income – as gauges of how big a misstatement must be before reporting is required.

To further complicate matters, the term *material definitive agreement* still needs defining. The SEC has indicated that a definitive agreement is a *binding agreement.* But what constitutes a *material definitive agreement* could have a dramatic effect on how companies disclose activity such as mergers and acquisitions.

The same day Merck lost Vioxx, PeopleSoft shed its embattled CEO, Craig Conway, to a boardroom ouster after Conway failed to adequately defend the company's finances from the impact of continued acquisition maneuvers by competitor Oracle.

SIDEBAR 2: NEW TRIGGER EVENTS

1. an unexpected entry into a material definitive agreement
2. an unexpected exit from a material definitive agreement
3. creation of a material direct financial obligation, including long- and short-term debt and capital-lease commitments, or an off-balance-sheet arrangement
4. the acceleration or increase of a direct financial obligation or a material obligation under an off-balance-sheet arrangement
5. material costs incurred during an exit from a business or disposal of an asset
6. impairment of assets
7. notice of a de-listing or failure to satisfy a continued listing rule or standard, transfer of listing, or completed interim review
8. a decision that previously issued financial statements or audit reports can no longer be relied on

What happens when you're PeopleSoft and the FUD (fear, uncertainty and doubt) swirling around the takeover has those hard-won enterprise software contracts running for the safer arms of SAP and Lawson? Suddenly an already tough third-quarter has your earnings so out of whack the stock takes the kind of beating that make Larry Ellison consider buying up shares on the open market. Do you disclose all those lost contracts, who made off with them and why?

A ROCK AND A HARD PLACE

So what can executives do to manage the risk of being caught by a material event that could go unreported because you didn't want to hint at your competitive strategy? One possibility is simply to file late.

Under a safe harbor, the SEC gives late filers a pass until the end of their current reporting period on many 409 triggers. A late filing won't cost a firm its eligibility to file an S-2 or S-3 short form when it raises capital, but there's no protection for incorrect reporting, which has become an infraction of Enron-sized proportions.

But late filing is no safety net. The pressures imposed by real-time reporting can add to the legal liabilities of finance chiefs and their bosses. Section 302 certification of financials by CFOs and CEOs says that executives must attest that they've installed adequate disclosure controls. Questions about disclosure control effectiveness could arise out of whether that late 8-K is a sign that management doesn't know what's going on with the business. If the company is perceived as incompetent at getting material information up to the C-suite fast enough, shareholder lawsuits against the company, the board and its executives become very real possibilities.

NEW TRIGGER EVENTS

Some executives are taking a longer-term approach to compliance by hoping to uncover problems early through scanning of operating-unit data. In addition to the 11 original triggers under Section 13, the SEC has added eight new triggering events to the criteria that should spur an 8-K filing. (See Sidebar 2.)

Think of the trigger that requires notification for an acceleration of an obligation. If a company takes advantage of a two percent discount for paying net 10 instead of net 30, must it be reported on an 8-K if the discount is large enough? This amounts to providing a new degree of granularity about a company's financial wherewithal that will have analysts looking far beyond more opaque metrics such as free cash flow.

Progress of a hostile takeover attempt by a competitor or the withdrawal of a major product from the market would obviously qualify as a trigger. Moving forward, it will be interesting to see how companies adapt to this new regulatory environment. But it will be even more fun to measure the impact of material events when guiding competitive approaches under both strategic and tactical circumstances.

A MATERIAL DEFINITIVE AGREEMENT

Thanks to two triggers, which call for a company to report its unexpected entry into or exit from *a material definitive agreement*, a CFO might learn on Monday that a big sales contract had been cancelled or even delayed, then be required to report it to the SEC and investors before the end of the work week. Within that time, the executive would likely have to call on accountants and lawyers to help define whether the event was indeed *material* and *definitive*. But the executive must also ponder the consequences enterprise-wide both for one's own, as well as competitors', ongoing operating income.

Equally important to the analysis of the event ex post facto is detection and recognition of the event in the first place. For this, only an early warning and scenario analysis system that harnesses the collective intellect of the firm to predict material events can approach satisfying so many diverse constituencies while also monitoring external environmental variables for impact events, such as those presenting themselves in the Merck example for a competitor such as Pfizer.

A BINDING AGREEMENT

As in many legal matters, interpretation is often semantic, but several significant competitively strategic consequences of the new rules are worth discussing. For example, the SEC hasn't yet said if the term *definitive* refers to a signed contract or a *binding agreement* in determining what must be disclosed.

Don't laugh; regulatory guidelines are what distinguish public companies and their rich set of signals of strategic intent present in associated announcements from private companies and their comparatively less transparent operating variables. Everybody knows it's tougher to get CI on private firms because of their relatively light reporting requirements and small number of shareholder constituents. The word *binding* isn't all that helpful either, both because it's more vague and encompasses many more possible transactions than companies are normally comfortable with disclosing publicly.

For example, one frequently undisclosed agreement is the *no shop* clause common in the early stages of M&A negotiations. How the term *binding* is eventually defined could have a dramatic effect on how companies disclose merger and acquisition activity and could even change how companies structure merger negotiations themselves. They might well avoid *definitive agreements* entirely, thereby routing around the need to disclose them in an 8-K in the first place.

Likewise, a misstep in timing the disclosure of a deal could create liability risks for companies. If a company's stock moves downward as the result of a late disclosure of an arguably material deal or event, shareholders could sue on the basis that the deal should have been disclosed sooner.

As a consequence, companies are likely to divide deals of any nature into binding commitments versus non-binding ones, a split agreement which might be useful if there's a natural break in a contract because part of it is fixed and another part of it is merely proposed. That might give a company some breathing room in disclosing the latter part of the deal or even disclosing the deal at all, if it's the second part that would make the entire arrangement *material.* But delays have risks of their own.

If the non-fixed latter part of the deal falls through, resulting in the need to exit from a material arrangement, shareholders could argue in court that the company disclosed too late, and, you guessed it, sue the pants off management and the board.

Violating the terms of a borrowing arrangement or loan covenant also suddenly becomes reportable. Before 409, a company had room to be in temporary breach of its debt-to-equity ratio until the end of the quarter when it could buy a waiver from the lender. That would enable the borrower to maintain the loan rather than pay it off on an accelerated basis. Now, however, a company might not be able to get a waiver quickly enough to avoid disclosing the covenant breach in an 8-K.

HOW CAN CI HELP?

What are the potential consequences of ignoring the renewed need for robust, world-class, and forward-looking CI at the corporate level? Corporate governance, after all, is the method by which we order the relationships and communications between a corporation's investors, board of directors and its committees, senior management, employees, auditors and legal counsel. From that perspective, the risks are clear.

What must be done is for CI teams to evangelize this new mission in corporate governance to business leaders at senior levels and demonstrate how early warning systems, scenario analysis tools, and CI techniques can be used to help fortify a firm's environmental predictability.

The consequences for a firm's employees, including senior management, of failing to pass the *market predictability test* inherent in a new age of SEC-enforced real-time reporting and risk management are dire indeed. The very real threat of business failure should not be underestimated. Consider the two real-world examples I've used above. PeopleSoft isn't the only takeover target to emerge in the business press lately. If Merck's stock doesn't quickly recover, it could look a lot more attractive to competitive suitors than it does to its own investors.

[Editor's note: Join Arik for an in-depth examination of the impact of Sarbanes-Oxley on the CI profession at SCIP's 20th annual conference in Chicago on April 6-9, 2005. More information is at *www.SCIP.org/chicago*, and invite your financial executives to join you.]

Arik Johnson is founder and managing director of Aurora WDC. More of his thoughts are available on his website at www.ArikJohnson.com *or call him at 715-720-1616.*