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# DIMENSIONS


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# Q&A with experts: How 2021 proxy design and disclosure trends may help you prepare for 2022

By *Dimensions* staff

Proxy statements continue to evolve. Along with updated SEC rules and guidance, companies are under pressure to adapt proxy disclosures to the shifting expectations and reading habits of investors. Filers thus have a compelling reason to revisit annually how they use the proxy statement to communicate and connect with shareholders.

For this Q&A article, *Dimensions* asked Toppan Merrill's Mike Spelman (Director of Proxy Solutions) and Karen Fisher (Proxy Advisory Services Expert) to discuss:

- handling proxy disclosures in 2021
- innovations to improve communication with shareholders
- hot topics in investor disclosure, including ESG, human capital, and the CD&A
- getting a jump on preparing for the 2022 proxy season

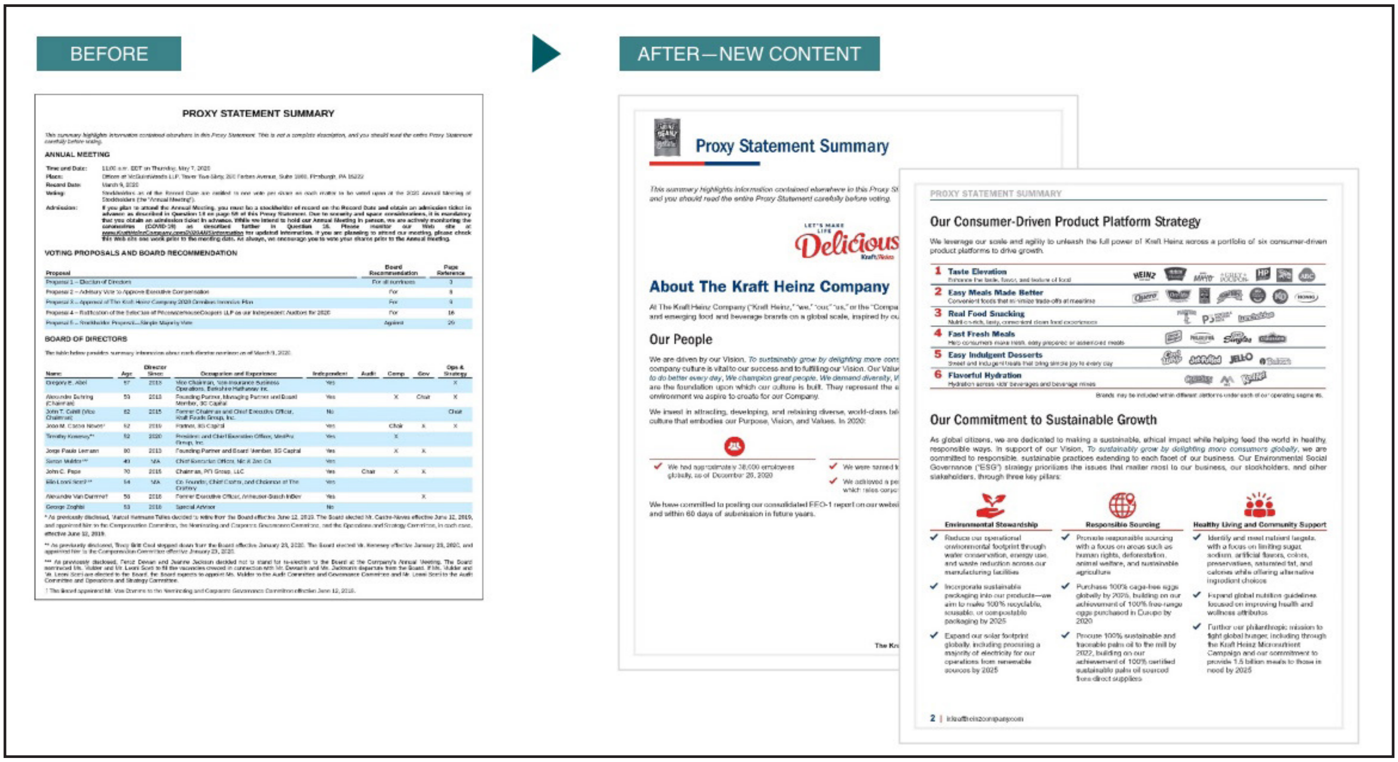
In addition to the answers and examples below, Mike and Karen joined a team of other Toppan Merrill experts in a presentation on these topics in a recent Toppan Merrill webinar: *2021 Trends in Proxy Design, Content, and Messaging*, which is available on demand. The examples of proxy statements shown below are from that webinar.

**What changed in 2021 in proxy presentation, design, and format?**

Several presentation and design elements took center stage in this year's proxy documents, including:

- a cover page to emphasize the corporate brand
- use of the Chairman/CEO letter to discuss strategic priorities and future objectives
- expansion of the ESG section, with a clear emphasis on human capital, diversity, and inclusion

In addition, many of our clients redesigned the proxy summary using photos, charts, icons, and graphs to break up dense text, making this section more readable. The following example is from Kraft Heinz:




### Has anything about proxy disclosures changed because of COVID-19?

The global effect of COVID-19 required companies to pivot quickly on how they operated, which affected not only employees but also customers. The COVID-19 pandemic heightened interest in human capital matters, with investors seeking engagement on many topics, including protecting the health and safety of employees and customers, remote working issues, succession planning, and the impact of these matters on business continuity. In addition, shareholders are interested in how the board handled its oversight of the challenges posed by—and management's response to—the pandemic, including executive compensation and corporate governance changes.

### What do you expect to be new for proxy statements next year? How can companies prepare?

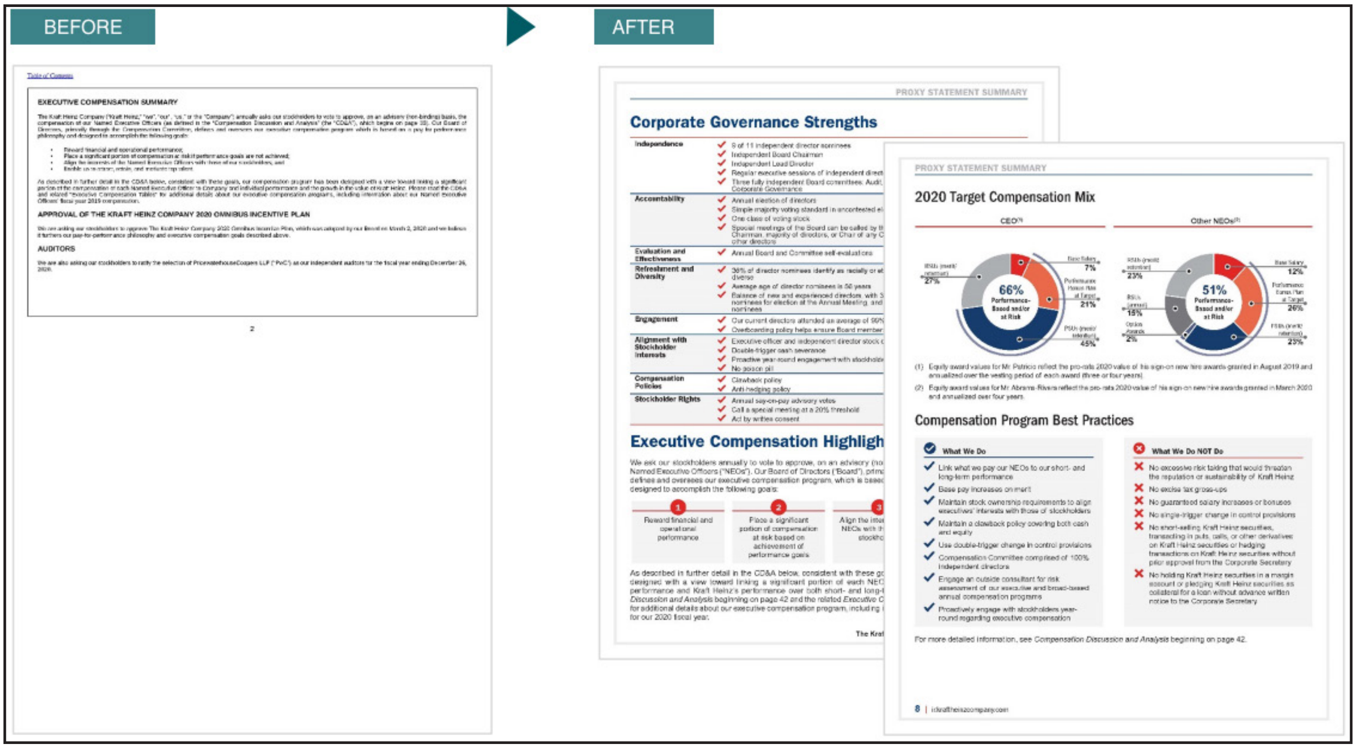
A continuing theme, which began this year, will be the expanded disclosure of ESG matters, board diversity, and human capital management, including employee diversity and inclusion. Even before the pandemic, human capital had been discussed within the ESG context, especially as issues such as board and workforce diversity and pay equity received greater attention. Now, as a result of the confluence of COVID-19, human capital disclosure is poised to play a magnified role in the 2022 proxy season. It is important for companies to begin now to think and discuss internally how this expanded disclosure will affect the consistency of messages throughout the proxy document.

### What makes a strong Chairman/CEO Letter?

Chairman/CEO Letters are an excellent way to create a personal bond between the company and its shareholders. Using this vehicle to communicate more than just the date and time of the annual meeting takes advantage of important real estate and can include a discussion of the company's investment in and betterment of global communities, a review of past successes and plans for the coming year, or financial and sustainability responsibilities and actions. Adding photos to the letter humanizes the executive leadership and further allows shareholders to build a connection to the organization.

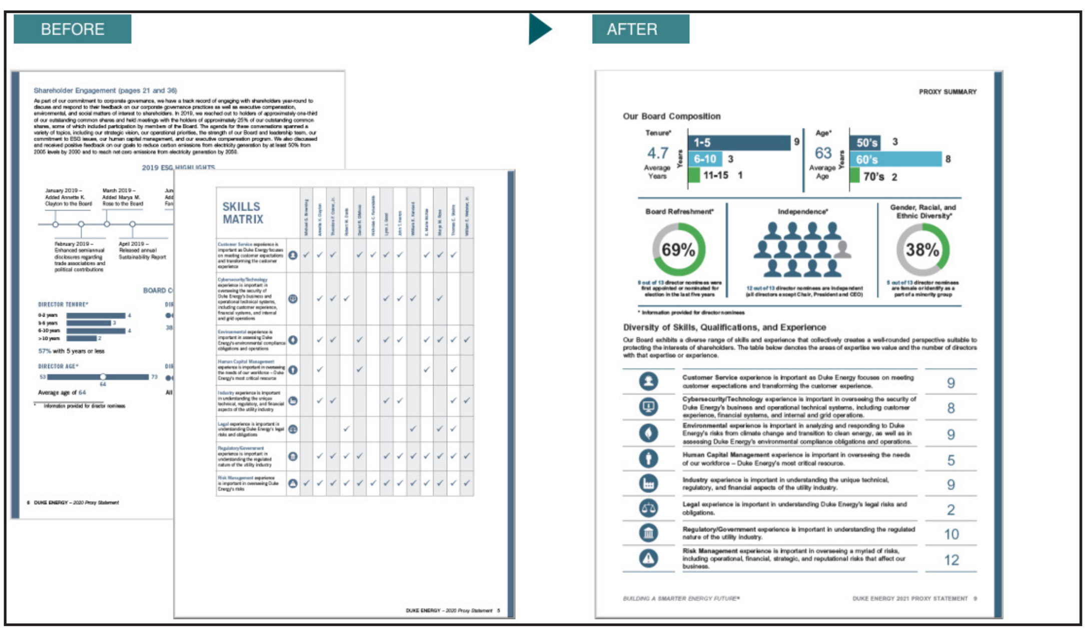
### What are companies doing to improve and expand disclosures on executive compensation?

There are several ways to improve these sections, including eliminating repetitive content and breaking up dense text with bullets for easier readability. Specific to the compensation section, we are seeing a trend in the highlighting of disclosure around individual Named Executive Officers (NEOs). Helping the reader understand the basis of performance goals and how those goals correspond to corporate results is extremely important for executive compensation packages to be accepted and understood by shareholders and proxy-advisory firms like ISS and Glass-Lewis. Highlighting positive say-on-pay results for the past five years, versus year over year, can also be very compelling.




### How are companies showcasing their board members or nominees?

The use of a board matrix provides a snapshot of board members' skillsets, tenure, diversity, and independence, among other important data. From this composite view, the reader transitions to the specifics of each individual board nominee.



Through color, photos, headers, bullets, and icons, a summary of each board nominee is consistent while reinforcing the thematic design throughout the document. Again, as with the CEO Letter, adding photos to directors' bios will draw a better connection for the reader and improve favorability.

**Why is risk management and cybersecurity one of the more critical proxy disclosures?**

Cybersecurity and risk management is intensifying, particularly with widespread remote working and increased online interactions. The rapid adoption of multiple business processes and protocols to enable this virtual environment has increased the potential for corporate attack and introduced new risks to the confidentiality, integrity, and availability of critical company data and support systems.

The return of employees to a physical workplace raises new data-security risks and privacy questions, with companies collecting data related to employee, contractor, and customer health, such as COVID-19 testing, temperature checks, and contact tracing. At the same time, developing new, disruptive technologies—and enabling the trust of stakeholders and the marketplace in doing so—is key to helping organizations lead, innovate, and differentiate. In this environment, board oversight and stakeholder trust in the company's practices for data security and privacy are strategic imperatives. Public disclosures can help build trust by providing transparency and assurance around how boards are fulfilling their responsibilities in cybersecurity-risk oversight.

**How are companies highlighting their ESG message?**

As noted, there is growing interest in ESG disclosure. The momentum for ESG disclosure has been boosted by various initiatives, including a number of large institutional investors calling for guidelines on proxy voting and engagement that address ESG issues. Several third-party frameworks for ESG disclosure have been growing in influence, such as the Task Force on Climate-Related Financial Disclosures (TCFD) and Sustainability Accounting Standards Board (SASB) frameworks. [See *Dimension's* interview with Madhu Mathew, SASB's Director of Technology.] BlackRock and Vanguard have expressly endorsed SASB and TCFD in their proxy-voting guidelines. State Street has developed its own R-Factor score to evaluate a company's ESG based on the SASB framework. Several organizations are separately rating companies based on their ESG, including Bloomberg, ISS, CDP, and MSCI. Therefore, it is advantageous that companies provide in their ESG disclosures the specific guidelines they follow and adhere to a regular update schedule.

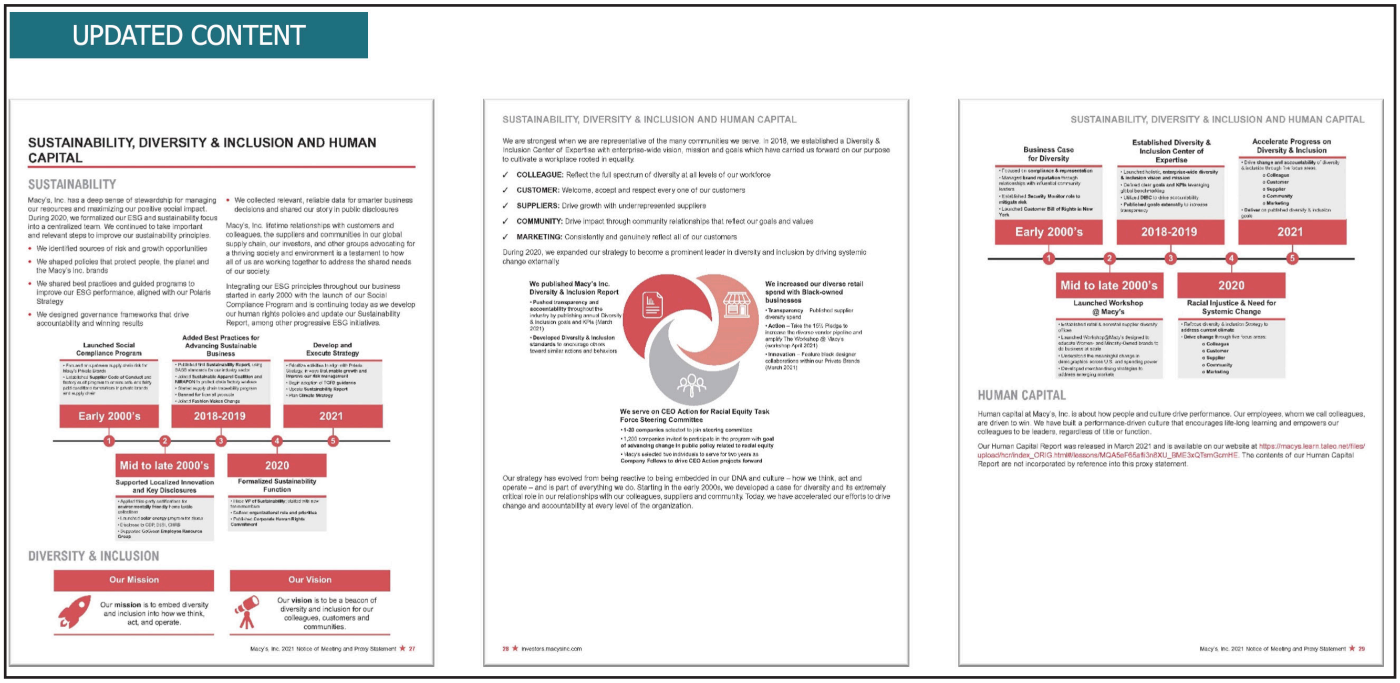
**How are companies making the CD&A information more accessible and understandable?**

The CD&A is among the most visible portions of the proxy. The objective should be to tell a clear and concise story. The flow of information should be presented in a meaningful and logical manner. Leading with a letter from the Compensation Committee is a trend we are seeing and provides an opportunity to shape the narrative and humanize the committee. Adding a CD&A table of contents highlights the key topics and provides a roadmap that acts as a navigation tool and guides the reader through the multiple charts and data.

**How are companies featuring their human capital management efforts?**

Proxy statements already require diversity and pay-ratio disclosure as well as board oversight disclosure. However, there has been recent pressure to increase human capital disclosure, including an amendment to Regulation S-K to address human capital in the business description. Some large institutional investors consider human capital management a priority for engagement, including BlackRock, which has made human capital management one of its priorities for its investor stewardship engagement.

In addition, proxy-advisory firm ISS has commenced an initiative requesting companies to disclose the self-identified race and ethnicity characteristics of board members. As a result, companies are enhancing their human capital management disclosure to include expanded board or workforce diversity, inclusion, or succession discussions, gender-based pay ratios, health and safety issues, employee training and development, and the board's role in human capital management and risk oversight.




### In what ways are companies highlighting shareholder proposals to garner more support?

We saw various ESG proposals during the 2021 proxy season compared to prior years. Proposals on environmental, social, or governance topics will continue to be the focus in the 2022 proxy season. In addition, as a result of the COVID-19 pandemic, there may be more proposals focusing on employee health and safety, as well as on human capital management generally. With racial and social justice issues attracting increased attention, companies may receive shareholder proposals targeting these issues, such as proposals highlighting employee diversity and equal opportunity.

Clear, transparent, and consistent messaging around shareholder proposals is extremely important: use of a consistent presentation and design format—including a clear and precise description of the proposal and the company's position, which has detailed explanations for shareholder support.

### How can companies' say-on-pay disclosure encourage more voting support?

During the 2021 proxy season, the say-on-pay proposal at most companies once again received majority approval. The average vote result was 90.6% in favor. However, it should be noted that the executive compensation voted upon in the 2020 proxy statement represented pre-COVID-19 decisions. It remains to be seen how investors and proxy-advisory firms will evaluate compensation decisions made in response to the global pandemic. Thus it is imperative that companies begin thinking about the desired focus and start drafting the specific language and designing the presentation sufficiently in advance to allow time for review by various company personnel and outside advisors, as well as to coordinate with disclosure being added to their annual report.

### How can companies communicate proactive shareholder engagement through the proxy statement?

Companies have an excellent opportunity in the proxy document to disclose their shareholder-engagement efforts. By using graphs, charts, and icons, a clear story about shareholder engagement can be told. It's important to include facts such as program details, how shareholders are contacted, who is conducting the outreach and how often, what the feedback themes were, and how that feedback was implemented throughout the organization. While a separate section for shareholder engagement should appear in the proxy, other sections should include themes such as corporate governance, ESG, and compensation.


# Do issuers use disclosure prominence of non-GAAP data to inform or mislead?

Abstracted from: *Disclosure Prominence And The Quality Of Non-GAAP Earnings*
By Prof. Jason Chen, Prof. Kurt Gee, and Prof. Jed Neilson
University of Illinois at Chicago (JC); Penn State University (KG and JN)
***Journal of Accountancy Research***
Vol. 59, No. 1, Pgs. 163-213

**The SEC's direction on producing disclosure.** Does a public company's compliance with an SEC rule on the prominent disclosure of non-GAAP data indicate something about the data's quality? Accounting professors Jason Chen, Kurt Gee, and Jed Neilson suggest there is indeed a correlation between compliance and quality. Under Regulation G, issuers must reconcile non-GAAP and parallel GAAP financial measurements in their public filings. Regulation S-K Item 10(e) applies to periodic reports, other SEC filings, and earnings releases provided under Form 8-K Item 2.02 (but not to conference calls). Strengthened in 2016, Item 10(e) requires companies disclosing non-GAAP financial measurements to present similar GAAP measurements as prominently or more so. Disclosing non-GAAP measurements more prominently is a violation that subjects the issuer to SEC scrutiny. The two rules were apparently a response to the regulators' belief that prominent non-GAAP measurements can mislead investors.

**Close-up of companies' performance.** Sampling 48,648 quarterly announcements by 4,715 companies, the authors examined companies with non-GAAP earnings per share in their 2003-2016 quarterly announcements. The study attributed non-GAAP prominence to those that had placed non-GAAP EPS before GAAP EPS or had altogether omitted it. Based on a manual check of prominence in 75 randomly selected announcements, the text-search algorithm used in the study was 92% accurate. The percentage of all companies that prominently reported non-GAAP EPS ranged from 16% in 2007 to 36% in 2015-2016. Among the criteria for gauging the quality of non-GAAP EPS was the inclusion of recurring items and additional expenses in the calculation. The researchers found that, on average, non-GAAP EPS was of higher quality among the issuers which gave it prominence, not only in company-to-company but also in non-GAAP-to-GAAP intracompany comparisons, and that most of the companies used prominence to inform investors, not to mislead them.

**Why spotlighted non-GAAP EPS is a cut above.** The authors explored two explanations for the correlation found between the prominence and the higher quality of non-GAAP EPS reporting. Suppose a willingness to bear regulatory costs were the cause? Then one would expect companies reporting non-GAAP EPS prominently in earnings announcements (which S-K Item 10(e) covers) as well as in conference calls (which 10(e) does not) to have reporting of higher quality than companies reporting it prominently only in conference calls. Finding little evidence of such higher quality, the researchers then compared two types of firms that were both unwilling to bear regulatory costs. Suppose a willingness to bear non-regulatory costs (i.e., market reactions) accounted for the correlation? Then one would expect companies reporting non-GAAP EPS prominently in conference calls—indicating such a willingness—to have reporting of higher quality than companies that never reported it prominently, indicating unwillingness. Here the study did find substantial evidence of higher quality.

**How investors act; plots to lead them astray; wider focus.** On market reactions, the authors find that when companies did not prominently report non-GAAP EPS, investors took longer and worked harder to digest the available public information before pricing the stock. When companies did report it prominently, investors rewarded them only if its quality was high. Although most companies employed non-GAAP prominence to inform the market, about one-third might have employed prominence deceitfully because they faced lower non-regulatory costs, namely less monitoring by media, analysts, institutional investors, and other market participants. Only a broader study can conclusively determine whether the SEC should further restrict non-GAAP prominence and, if so, how. One unexplored area is the association between reporting prominence and the quality of other non-GAAP measurements, such as revenue. Another is the consequence of companies' decisions to use non-GAAP prominence, not just the incentives to do so.

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Abstracted from ***Journal of Accounting Research***, published for University of Chicago Booth School of Business by Wiley, 111 River Street, Hoboken NJ 07030. To subscribe, visit *https://onlinelibrary.wiley.com/journal/1475679x*. Article available at *https://onlinelibrary.wiley.com/doi/epdf/10.1111/1475-679X.12344.*

RECENT DEVELOPMENTS

# Trends in human capital disclosure under a revised SEC requirement

By *Dimensions* staff

So the SEC has revised its rule on human capital disclosure under Regulation S-K. Now what?

Disclosure about a company's workforce has, in many ways, always been a de facto requirement for filers, as that information is intrinsically material and investors will sooner or later demand it. Nevertheless, the revised SEC rule under Reg S-K last year spelled it out officially (see Rule 33-10825, finalized on November 9, 2020). The final rule formally requires, "as a disclosure topic, a description of the registrant's human capital resources to the extent such disclosures would be material to an understanding of the registrant's business."

Specifically, the SEC wants filers to express how the company's human capital contributes to corporate value and strategy. However, its principles-based approach furnishes only a very general set of expectations. The final rule states that filers must "provide a description of the registrant's human capital resources, including in such description any human capital measures or objectives that management focuses on in managing the business, to the extent such disclosures would be material to an understanding of the registrant's business taken as a whole."

How have corporate filers responded to this revised rule in their SEC disclosures? Research reports from expert observers reveal the early disclosure trends, provide insightful comments on them, make recommendations for filers, and even provide an impression of early reactions from the SEC staff.

### Longer but not necessarily more informative

One noteworthy examination of early trends in human capital disclosure under the amended SEC rule comes from a team comprising academics at Stanford University Graduate School of Business and consultants at the research firm Equilar. In their assessment, *Human Capital Disclosure: What Do Companies Say About Their "Most Important Asset"?*, they suggest that the early disclosures offer few meaningful insights for investors. "We find that while some companies are transparent in explaining the philosophy, design, and focus of their [human capital management], most disclosure is boilerplate." The disclosures often lack quantitative metrics, so "the new rules appear to contribute to the length but not the informativeness of 10-K disclosures."

The researchers looked at human capital management (HCM) disclosures in the first 100 Form 10-K filings by companies with market caps of at least $1 billion made after the SEC's November 2020 rule revision. This yielded a sample of what these companies opted to disclose about human capital before the filers had gotten a chance to see what their peers were disclosing. The researchers found the following were the most common new disclosure topics:

- diversity and inclusion (61% of the companies)
- employee development efforts (55%)
- safety (51%)
- compensation practices (37%)
- employee-engagement efforts (25%)
- employee turnover or tenure information (22%)

The researchers were struck by "the exceedingly generic nature of the language used." Furthermore, just 43% of the companies filed quantitative metrics to back up their new disclosures. Even with metrics, most of the data were easy to obtain, such as gender diversity (24% of the companies offering quantitative metrics), racial diversity (14%), average employee tenure or voluntary turnover (14%), and safety-related incidents (12%).

"These numbers demonstrate the paucity of quantitative metrics and underscore the generic nature of early HCM disclosure," lament the researchers. "Without concrete figures, it is difficult to believe that investors will be able to monitor a company's HCM performance, make reasonable assessments about its performance relative to peers, or understand the dollar investment that a company makes to support the development of its employee base."

To underscore their point, the authors cite examples of filers that did make thorough quantitative HCM disclosures about key topics, noting that "these metrics demonstrate the potential value of concrete disclosure to shareholders." They conclude by hoping that "market pressures coalesce around more uniform and higher-quality reporting standards—as corporate disclosure is held up against peer groups."

### Patterns in early disclosures

Reseachers from FW Cook made a similar study of human capital disclosures in the first 50 Form 10-K filings after the SEC's revised rule became final *(10-K Filings Show a Variety of Approaches to the New Human Capital Resources Disclosure Rules)*. The study plumbs fine details of these disclosures, such as word count (shortest is nine words, longest is 1,582; median is 369), and considers the strategic approaches to compliance with the amended rule.

Some filers "essentially repeated the disclosure from their last 10-K," often just the total number of employees. Others simply referred readers to other documents for further information, but "it is not clear to [the researchers] that this cross-referencing technique works to the extent that the referenced information is necessary for the 10-K to be complete, since the SEC rules do not appear to allow incorporation by reference for this information."

Among filers that provided more information, the most significant types of disclosure are "extensive headcount data" (60%), followed by:

- diversity and inclusion (54%)
- employee development and training (50%)
- competitive pay/benefits (36%)
- safety (36%)
- employee benefits (32%)
- culture/values/ethics (26%)
- employee engagement (24%)
- tenure/promotion/turnover (22%)
- recruitment (22%)
- mental health (14%)

A more pointed assessment is delivered by *Human Capital Disclosure Report: Learning On The Job* from the research firm Intelligize (available for download at *Companies Avoid Revealing Human Capital Metrics*). The firm's criticism is not restricted to filers. In its view, the generalized wording in the SEC's new rule actually "gives leeway to companies that would rather not disclose much about their employees, or how they are treated."

Intelligize surveyed a relatively large sample: human capital disclosures in 427 Form 10-K statements by S&P 500 companies, filed between November 9, 2020, and March 5, 2021. Like other researchers, the Intelligize analysts find that most of these early human capital disclosures avoided concrete data and retrospective information in favor of generalized “aspirational, forward-looking goals.” Some filers that omitted quantitative metrics at least used the disclosure to write about specific subjects in human capital of interest to investors. A small minority of filers went further with “far more robust disclosures, which included data in the form of tables and graphs to illustrate key information.”

However, this rare data-driven approach is above and beyond what the letter of the SEC’s revised rule requires. While the researchers note that most of the surveyed filers made “sincere efforts” to talk about their workforces, filers also “capitalized on the fact that the new rule does not call for specific metrics. Relatively few issuers provided meaningful numbers about their human capital, even when they had those numbers at hand.”

In short, conclude the Intelligize authors, the SEC’s principles-based, rather than prescriptive, approach to human capital disclosure leaves the presentation of meaningful data up to filers: “Without a mandate to provide any particular data on their workforces, most filers declined to provide them.”

### Recommendations for filers

While its survey of human capital disclosures observes similar patterns to those found by other firms, PricewaterhouseCoopers (PwC) also includes extensive recommendations for filers in its report on the revised SEC rule, *New Human Capital Disclosures: Getting Your Company Ready*.

“Quality data is foundational to disclosures,” the report emphasizes. It points out the need for a review of the company’s disclosure controls and procedures (DCP) to ensure that the right data is being captured. It also urges consistency of these steps across filings, from the annual report to disclosures that may have a separate set of controls and procedures—for example, registration statements.

PwC offers questions for filers to ask when considering human capital disclosures, such as:

1. What is the quality of the data underlying the disclosures?
2. What governance exists over this data? Does it flow through the disclosure committee, board, or audit committee?
3. Based on the type of filing, are the disclosures subject to DCP, or are there other processes and controls that support the reliability of the information reported?
4. Is there a policy on scoping, measuring, and presenting the information to aid consistency between periods?
5. Will consumers of the human capital information be confident in its accuracy and completeness?
6. Is there a process for determining when changes to measures are needed and disclosed?

### Feedback from SEC staff

In a companion podcast, *Human Capital Disclosure Trends in Recent 10-K Filings*, the PwC team references early staff feedback that filers have received. The SEC staff singled out some filers that disclosed only generic qualitative statements (“boilerplate information”) and asked them to be more quantitative in light of the expanded requirements.

While PwC’s podcast commentators note that many companies did successfully identify material information and provide qualitative discussions of their human capital realities and programs, the disclosures were “very limited on the quantitative side,” in the words of Brandon Yerre, a principal in PwC’s Organization and Workforce Transformation Group. However, he expects that companies will now focus on connecting these qualitative evaluations to data showing actual results that “quantify and explain to shareholders the quantitative impact of their actions” in matters of human capital.

## About *Dimensions*

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