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As Data From New Gadgets Mounts, Companies Struggle With Record-Keeping

By Tiffany Kary

Bank of America Corp. took nearly two years to provide the Securities and Exchange Commission with evidence requested as part of a probe, resulting in allegations it had stalled, and a \$10 million fine.

The bank accepted the fine without admitting wrongdoing, an absolution skeptics question given the languorous pace at which information was produced. But legal experts say two years is nothing considering the morass of data now produced by e-mail, new mobile gadgets and digital calling technologies. Many companies could run afoul of the SEC's hard line on cooperation whether they intend to or not, due to the sheer volume of data they have to wade through. Firms could also rack up some outrageous bills as they scramble to answer investigators' demands if they don't get data archiving up to speed, lawyers caution.

"There is in effect a silent conspiracy, being driven not by litigators or executives but by the technology side of the company which results in the increase of data files and the ability to turn those files into evidence," said William Tanenbaum, international chair of the Technology, Intellectual Property & Outsourcing Group at law firm Kaye Scholer LLP.

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GOVERNANCE MATTERS

A Point Of View Column

Votes Have To Count For Director Reform

By Neal Lipschutz

Giving real meaning to the votes cast or withheld in elections of U.S. corporate directors is the minimum needed to achieve substantive reform.

That notion comes to mind after The Wall Street Journal reported recently that the ground may be shifting in the long-standing attempt to give large shareholders more say about who gets nominated to boards of directors.

The Journal's Deborah Solomon reported Securities and Exchange Commission Chairman William Donaldson is considering toning down the complex and much-argued-about proposal that under certain circumstances would allow large holders to place up to a few director nominees on company sponsored proxy materials.

Business groups have been intensely negative about the plan, viewing it as an invitation to special interest directors and potentially dysfunctional and adversarial boards. Large

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Surveys Show Earnings Missives Still Lack Candor

By Tiffany Kary

Two recent surveys have skewered the ornate governance practices springing from Sarbanes-Oxley legislation, pointing out that companies still fail the most obvious mark of good governance: candor.

As companies spend millions to comply with legislation designed to restore trust in the capital markets, many still appear intent on hiding their true financial health. According to two separate studies - RateFinancials' survey of Securities and Exchange Commission filings and Rittenhouse Rankings' analysis of annual proxy letters - many companies still aren't being entirely up front in key communications with stockholders.

"Should companies improve their candor and specificity? Yes, they need to give that information," said Carol Bowie, director of governance services at Investor Responsibility Research Center, a Washington-based proxy research firm. Bowie added that while savvy investors recognize that shareholder letters are "a PR exercise" for most companies, executives should devote more care to what goes into all communications with shareholders.

"We don't see it as a good sign for the market that we've found such a large number of poor and below-average companies."

-Victor Germack, RateFinancials

Far too many publicly traded companies don't accurately portray their financial condition, according to New York-based research firm RateFinancials. The study classified 47% of financial statements it reviewed as acceptable, while 14% were "below average" and 1% were "poor." Only 3% were "outstanding," and 35% were "superior." The study covered filings from the past year issued by 120 companies in the S&P 500, which together account for close to 42% of the index's market cap.

"We don't see it as a good sign for the market that we've found such a large number of poor and below-average companies," said Victor Germack, founder and president of RateFinancials.

Factors that went into the rankings included the directness with which a company reported its earnings, clarity of footnotes, aggressiveness of accounting, and good governance policies such as heavily independent boards and responsible related party transactions. Directness with which earnings were reported was weighted most heavily in the study, accounting for 50% of a company's overall rating.

RateFinancials named names: outstanding companies included BMC Software, Family Dollar Stores and Microsoft. Those ranked below average included Archer Daniels Midland, Halliburton, Best Buy, Bristol Myers Squibb, Corning, Eastman Kodak, EDS, Gap, Janus Capital, Motorola and Walt Disney Co.

The only company rated "poor" was Computer Associates. While RateFinancials has yet to correlate its rankings to share price or governance imbroglios, Computer Associates has been plagued by high-profile problems this year, including an accounting probe and management departures.

The study uncovered other unsettling trends: 75% of companies used complex financing to shift long-term financial obligations off their balance sheet; 64% made unreasonable assumptions about future pension liabilities and 28% used aggressive revenue recognition techniques.

Rittenhouse Rankings, a service that measures candor by analyzing how earnings are presented in annual proxy letters, has found a similar trend: 87% of chief executives failed its candor test, as measured by how they report bottom-line performance in their letters. Some of the worst offenses were failure to reconcile GAAP and non-GAAP earnings, and liberal use of aggressive pension forecasts and tricky off-balance sheet accounting.

The survey covered letters contained in annual reports for companies' fiscal 2002, ranking a representative sample of 100 companies from the Fortune 500. A study of 2003's letters is currently underway.

While both studies came up with similar revelations about corporate candor based on very different methods, there was little overlap in their lists of best and worst performers. JetBlue Airways, Knight Ridder, Wells Fargo, Continental Airlines and Estee Lauder were the top five companies according to Rittenhouse's survey. Boeing, Reebok, Time Warner, Trump Hotels and Franklin Resources were the bottom five, with Boeing at the bottom of the list.

L.J. Rittenhouse, president of AndBeyond Communications, which authors the study, said that while many institutional investors overlook the annual proxy letter, it is a better litmus test for financial well-being than actual earnings results.

"Most investors focus on financial numbers, but they forget that those numbers are being filtered through management judgments," Rittenhouse said. "What our study has shown is that companies which choose to disclose information in a shareholder letter

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Earnings Missives... *(continued from page 3)*

with great candor probably make those other decisions with great candor.”

Famed investor Warren Buffett has also called the shareholder letter the primary document of a corporation, and he serves as a star example by producing an honest, readable letter for Berkshire Hathaway shareholders every year, Rittenhouse added.

“This is where a chief executive exposes him or herself to the world - shows if he or she understand the business, and can articulate to shareholders what’s going on,” she said.

Rittenhouse looks for four main things other than lucid writing and sound judgment: whether a company includes diluted earnings per share for the current as well as prior years, whether that number matches the earnings per share number in the company’s income statement, whether the company reconciles GAAP and

non-GAAP earnings, and whether they clearly explain year-over-year variations in earnings.

Companies have shown themselves to be surprisingly devious - Rittenhouse cites a Enron Corp.’s financial report for 2000, before any of the company’s more serious problems surfaced. “Enron’s 2000 report was classic. It claimed in the first paragraph that net income was over a billion dollars for the first time. But if you looked at the income statement, it was \$978 million - more than a rounding error - and there were no footnotes to explain the difference,” Rittenhouse said.

Unlike RateFinancials, Rittenhouse Rankings did analyze share price performance’s link with candor. Unsurprisingly, the study found that over the past two years, top-ranked companies in the survey have seen share prices increase 21.5%, while bottom-ranked companies increased just 7.3%.

Value Proposition... *(continued from page 7)*

Audit firms also said it was impossible to gauge how much new business they might bring in for themselves from this new line of consulting.

“Audit firms are marketing directly to the company, through direct mail, Sarbanes-Oxley compliance guides, and seminars,” said Koltin. “What they aren’t doing is talking publicly in the marketplace about this new lucrative area - because the words lucrative and public accounting firm just shouldn’t be seen together.”

Still enmeshed in inquiries over aggressive tax shelters they sold to companies during the 1990s, and stinging from the reputational shadow cast by Arthur Anderson’s demise, the accounting firms are shy about boasting new revenue pockets. The fact that the new consulting boon is a direct result of legislation is also bound to incite accusations that the government is helping auditors out rather than clamping down on them, Koltin added.

“This is going to be a substantive new business,” said Mark Cheffers, chief executive of Auditanalytics.com, an independent accounting research firm, who noted that many firms are likely to be tempted by the prospect of combining audit and non-audit work around section 404, but likely to steer clear of it given the SEC’s new vigilance on the matter.

“The last things those firms would want is for one company to do the audit work and another firm to come in and reap the consulting benefits,” Cheffers said.

KPMG and Pricewaterhouse Coopers have both articulated strong stances on keeping the new consulting work separate from audit services. “We don’t pursue this with our audit clients,” said Hill.

“You won’t see this listed as a disallowed service. But if it’s a grey area, we’re not going there with our audit clients,” said DiFillippo.

While the firms are approaching the issue with caution, Cheffers notes that there are many potential pitfalls. KPMG has a relationship with IBM to develop software related to compliance. Should a company that retains KPMG as an external auditor use the software, there is some possibility for conflicts to arise, depending on the fee structure that exists between KPMG and International Business Machines Corp., he noted.

Auditing firms are being cautious on conflict areas while the SEC has yet to give any final rules on whether such work could be done as part of actual audit services. But skepticism about such services is bound to prevail, especially as most firms couldn’t give concrete evidence of how they actually intend to help clients make more money out of being compliant.

CORRECTIONS

An article appearing in the June 9 edition of *Dow Jones’ Corporate Governance* newsletter, “Cintas Lawsuit Could Set Dangerous Precedent,” gave an incorrect figure for Cintas’ lawsuit. The lawsuit seeks \$75,000 in damages, not \$75 million.

The article “Director Conflict Raises Questions For Best Buy, Ernst & Young” in the June 9 edition incorrectly stated that Mark Thompson had received \$186,000 in payments from Korn/Ferry International in fiscal 2003. Instead, Best Buy paid Korn/Ferry \$186,000 during that period.