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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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Governance Matters... *(continued from page 1)*

pension plans and other big institutions, on the other hand, have argued boards ignore their desires and ownership rights and force them to launch expensive proxy fights if they object to board nominees.

Now, the Journal reported, Donaldson is exploring an alternate that would at least put value in the votes for or against nominating-committee-selected candidates.

Right now, once a nominating committee picks a candidate, he or she will be elected to the board, even if most votes are withheld for that candidate, indicating shareholder displeasure with the choice. Even overwhelming shareholder sentiment against a director has no binding power.

That doesn't sound like a real election under any definition.

The Journal says Donaldson is mulling a proposal that says if more than 50% of cast votes are withheld from a candidate, the nominating committee can replace the candidate. Other possibilities include requiring consultation with large holders on such a replacement, or granting shareholders the ability to nominate if the replacement also gets less than 50% of the vote at the next election, the Journal said.

This way of thinking starts to sound like a plan offered in April by ex-SEC member Joseph A. Grundfest, who is now a professor at Stanford Law School.

Grundfest suggested a rule that says if a candidate doesn't get a majority of votes (or some other designated level) the company wouldn't realistically be able to put the person on the board.

The plan, supported by a trade group representing corporate secretaries and Barclays Global Investors, gets a bit complex because it acknowledges varying state laws are important in how boards are assembled. In essence, though, the plan says a majority vote withheld would mean the person doesn't get to serve.

An up-or-down vote having the desired impact sounds more like a real election. It should be the minimum accepted by the SEC when commissioners finally vote on this important and long-simmering issue.

A majority-vote rule doesn't allow large shareholders the restricted but real ability to put up their own candidate or two after certain "triggers" have been activated. That ability is granted by the proposal now on the table.

But Grundfest argued that under his plan, there would be a real-world incentive for nominating committees to consult beforehand with interested shareholders. No nominating committee wants its hand-picked person to be very publicly knocked out in an election.

"The result will, we believe, be a less confrontational mechanism that constructively engages shareholders in the process of nominating and electing directors," Grundfest wrote.

Large pension funds and state treasurers, who have been so active in corporate reform, aren't likely to be pleased by Donaldson's reported change in thinking. Some institutional shareholders think the current proposal is already too restrictive about when large holders get to put up a nominee or two on company proxies.

But if the realm of what's possible is now changing, another April letter to the SEC may be telling. It's from Institutional Shareholder Services, the proxy voting and corporate advisory firm.

After saying it wanted the current SEC plan adopted, ISS said it saw merit in the Grundfest program and in meaningful elections of company picked candidates.

Speaking of the Grundfest proposal, ISS wrote: "While it does not offer a means for shareholders to have their own nominees included in a company's proxy materials, it does provide strong incentives for companies to seek majority-vote election of all directors."

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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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Small Firms Shy Away From IPOs As Compliance Costs Rise

By Tiffany Kary

Joe Fiore didn't mince words when Knock-Out Technologies Ltd., a Dover Plains, NY-based maker of food technology, approached him about going public.

Fiore, chairman of Scarsdale, NY-based Berkshire Capital Management Co., quickly ascertained that the company only had about half the \$125,000 to \$150,000 in free cash flow he reckons is necessary to meet the costs of complying with Sarbanes-Oxley.

"If they don't have it, I tell them up front; these costs are not optional," said Fiore, who said he meets with seven to eight companies seeking to go public a month.

Knock-Out Technologies thus bowed out in an early round of its bid to become a publicly traded company, despite what Fiore described as promising technology: a germicidal spray that can eliminate six major types of bacteria.

The story doesn't end badly. Fiore, a self-described rabbi for small private companies, set Knock-Out up with e-FoodSafety.com, an over-the-counter Bulletin Board-listed grocery tracker which acquired Knock-Out in May, giving it enough capital to overcome what could have otherwise been mortal costs associated with Environmental Protection Agency-mandated testing.

Much has been written about the potential long-range effects of Sarbanes-Oxley on U.S. markets. The effects range from public firms that opt to go private to avoid the high cost of compliance - such as prepaid phone card firm 9278 Communications - to foreign firms that shy away from listing on more stringent U.S. exchanges - German car maker Porsche and Japanese brokerage Daiwa Securities Group, for example. But it is the small all-American start-up which may be most affected by the high cost of compliance.

The average cost of being public for a company with annual revenue under \$1 billion has increased 130% to \$2.13 million from the inception of Sarbanes-Oxley in 2001 through fiscal 2003, according to a study from law firm Foley & Lardner.

According to the study, which surveyed 115 companies, the biggest cost increases came from lost productivity, board compensation, and director & officer (D&O) insurance. From fiscal 2002 to fiscal 2003, D&O insurance rose 33%, board compensation rose 48%, and most dramatically, fees from lost productivity, as staff and costs were channeled into compliance work, rose 72%.

A rise in audit fees also hit companies hard, up 23%, according to the survey.

"The government shouldn't expect that these companies have the same kind of resources Microsoft Corp. does," said Frank Speight, Chairman of the Small Public Company Capital Formation Club, a new lobby group being created by The Club For Growth, an antitax group that supports conservative candidates.

In addition to lobbying for a reduction in the regulatory burden on small companies, the group, which will officially launch in September, also plans to champion easier access to capital.

Speight, also CEO of West Palm Beach-based American Capital Partners Ltd., estimates that of the 100 or more companies he meets with each year, only five to 10 will decide to try for an initial public offering. Speight, who has been in business since 1991, said the current rate is a considerable drop from past years.

High costs scare most companies off. Like Fiore, Speight said companies need around \$150,000 in free cash flow to be able to meet Sarbanes-Oxley costs. That doesn't include the rising costs associated with the need to attract independent directors, he added, noting that D&O insurance policies can set a company back as much as \$100,000 per head.

Speight, who meets with about 10 companies a month, said he currently has 20 clients who are deciding whether to scrounge together the fees or just stay private.

"In a lot of cases these companies end up going to their friends, families, neighbors and loved ones to borrow the money. But that just puts them further behind the ball," he said.

In Fiore's experience at Berkshire Capital over the past year, 80% of private companies are barred from going public by the high costs of Sarbanes-Oxley, which necessitates hours of high-priced legal counsel and auditor consulting.

The costs of Sarbanes-Oxley aren't lessening as companies become more familiar with it, either. According to AMR Research, a market research firm, Sarbanes-Oxley compliance costs are expected to rise in 2005, up from an estimated \$5.5 billion aggregate for U.S. companies in 2004. And 35% of companies in a recent AMR survey said costs are running above plan for 2004 already. AMR doesn't study the particular impact on small businesses, but John Hagerty, a researcher with the firm, notes that it's simply a matter of scale.

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Panel Calls For More User-Friendly Financial Statements

By Phil McCarty

The accounting industry and its primary product, audited financial statements, must be modernized, a panel of industry experts said recently.

"Accounting standards are based on 70-year-old concepts and they need an overhaul," said Roderick Hills, a former Securities and Exchange Commission chairman and partner at the law firm Hills & Stern in Washington.

Hills, speaking at the American Enterprise Institute, a Washington public policy research group, called for accounting standards to move toward a more principles-based system and away from incremental rules. But he and fellow panelist James Doty, an attorney at Baker Botts in Washington and a former SEC general counsel, said rules can't be abandoned all together.

Doty said there needs to be a balance between a rules-based accounting system and a principles-based system.

Essentially, Hills, Doty and others are calling for more flexible financial accounting standards in order to make financial statements more user friendly, and to dispel the illusion that audited financial statements provide investors with certainty about a company's financial position.

Hills said financial statements need to have a wider array of non-GAAP (generally accepted accounting principles) financial data, and should also include other, non-financial data.

The idea is to give people more information with which to compare companies within a specific industry, and to give greater insight into a company's past performance and future prospects, Hills said.

Panel members agreed the envisioned flexibility may give rise to more complex and volatile financial reports, but most maintained that financial statements currently prepared under GAAP rules give the false perception of exact measurement.

In reality, there are usually several different accounting methods and assumptions that firms apply to any number of transactions. For example, inventory accounting methods differ among firms, as do depreciation methods and pension accounting assumptions, just to name a few.

"The search for certainty in accounting numbers is a foolish quest," Hills said.

Donald Marron, executive director and chief economist of the Joint Economic Committee of Congress, proposed adding an estimate of precision to line items in financial statements.

Each item in the statement would have the figure estimated by the company and attested to by its auditors as well as a variance term, or a range in which the number falls. For example, cash and marketable securities would have a very low variance, or high precision, while intangible items may have a wider variance, or low level of precision in measurement.

Peter Wallison, author and resident scholar at AEI, noted that the misperception about accounting accuracy is at the "root of many of the accounting profession's problems."

"As long as investors and the public generally believe that the EPS number has some inherent precision, the profession will continue to incur liability for things it really cannot control," he argued.

And liability is really the key obstacle in moving forward with changes in the profession, Hills said.

He argued that the more auditors and management follow principles-based standards and the judgements that must be made under those standards, the more they will be exposed to litigation.

Hills also called on the SEC and the Public Company Accounting Oversight Board to provide some protection to the profession from frivolous lawsuits.

Small Firms... *(continued from page 4)*

"It's like regressive taxing, small companies end up paying more," Hagerty said, adding that companies with decentralized operations also suffer more from high compliance costs.

Even for companies which decide to stay private, the presence of Sarbanes-Oxley is still felt.

"Venture capital firms, auditors, are telling private firms: 'if you want access to capital, you need to prove some compliance as well,'" Haggerty said.

Financiers in the private sphere also noted that regulators' increased vigilance on good governance is putting pressure on small company financing from other angles. Increased scrutiny of so-called "shell companies" by the Securities and Exchange Commission is threatening a long-time strategy for small private firms: reverse mergers into public companies known as shells, those with few or no assets or operations.

"These types of mergers weren't negatively thought of before. They were very practical," said Speight.

Levitt Takes On Reform Skeptics, Including Thain

By Phyllis Plitch

Taking issue with concerns raised by the New York Stock Exchange's top officer about the costs of complying with new corporate governance rules, Arthur Levitt, former Securities and Exchange Commission chairman, reaffirmed his support for the sweeping reforms.

In particular, Levitt zeroed in on the section of the nearly two-year-old Sarbanes-Oxley Act that calls for stronger internal accounting controls, which has caused widespread angst among financial executives and also was "at the heart" of the recent issues raised by New York Stock Exchange Chief Executive John Thain and others.

In remarks to a group of investor relations officers, Levitt acknowledged that the expense of complying with Section 404 could be high for some companies. But whatever financial burdens are associated with the rule pale in comparison to the risks to shareholders if internal controls aren't tightened, he suggested.

"This part of the act is essential to ensuring companies are able to provide the information that investors need and deserve," he said. The cost, he said, is "a fraction" of the billions that investors have lost as a result of financial restatements in the last couple of years.

Compliance is costing as much as it is because "many companies lack adequate controls in the first place," he said. If each Fortune 1000 company spent \$5 million to comply, it's "pocket change compared to the \$90 billion lost by investors on Enron alone," Levitt said.

Addressing - or as he put it, "preaching" - to members of the National Investor Relations Institute gathered for their annual meeting, Levitt cited Thain's recent critique in *The Wall Street Journal*. "The new CEO of the NYSE took to the pages of *The Wall Street Journal* to argue that Sarbanes-Oxley is too onerous on business," and could chill economic growth, he said.

In a May 27 op-ed piece, Thain offered support for Sarbanes-Oxley's goals and corporate governance reforms in restoring confidence to the markets. But he said the rules "should not become the enemy of economic performance." Thain, who also addressed the burden on foreign companies listed in the U.S., proposed bringing listed companies together to further discuss the costs and benefits. An NYSE spokesman reiterated that Thain lauded the legislation, but that he wants to make sure that corporate governance and

better economic performance not be at odds with one another. He added that Thain's piece and a speech that preceded it reflected what he is hearing from CEOs of listed companies.

The main thrust of Levitt's speech was to offer up "guiding principles" for corporate transparency and disclosure in the age of Sarbanes-Oxley.

Among other things, companies should be disclosing key performance indicators, a set of statistics, he said, with "enormous predictive capability."

"Management knows what metrics are important in their industries and providing shareholders with these numbers will give a clearer picture of where companies are going," he said. And when companies impart such information, "it should be in plain English," a long-time theme of the former regulator.

*in*BRIEF

Calpers Issues Broad Plan On Investments, Policies

The California Public Employees' Retirement System approved a wide-ranging annual plan that indicates it will review its governance and invest in higher-risk real estate ventures in the coming year.

Establishing best practices for hiring and firing firms that manage money for the \$165 billion pension fund is a key part of the plan, Calpers said in a document posted on its Web site.

Calpers' board approved the annual investment office plan this week, said Brad Pacheco, a spokesman for the pension fund. It provides the public with an early look at what to expect from a major institutional investor: with \$165 billion in assets, Calpers is the nation's largest public pension fund.

The plan covers Calpers upcoming fiscal year, which starts in July.

"It's a clue as to the direction we're heading," said Pacheco. "These initiatives will go before the board separately throughout the year for refining in some cases, and final approval."

Corporate governance issues loomed large in the plan. While Calpers has a long history of corporate activism, it was involved in particularly high-profile shareholder rights battles this year, most notably against The Walt Disney Co. Calpers pushed for governance improvements at numerous companies, focusing on clearing up corporate audit committees and separating the roles of board chairman and chief executive officer. Now, it is turning its sights on its own governance policies.

"In July, our board will have its strategic off-site and we're going to do a soup-to-nuts review of our corporate governance program," said Pacheco.

Calpers also singled out a strategy for investing its \$11.5 billion real estate portfolio, saying it intends a shift to higher-risk ventures. The pension fund wants to make a gradual shift from core real-estate investments - which it defines as stable, income-producing, and lower risk - to non core ventures it calls opportunistic and higher risk.

Auditors Sell Value Proposition To Compliance-Weary Clients

By Tiffany Kary

"Compliance is like when the club hits the ball. Can you imagine a swing without a follow-through?"

With eloquent metaphors such as this, dropped into Deloitte & Touche Deputy Managing Partner Tom Schiro's recent presentation to a conference of compliance officers and auditors in New York, big audit firms are launching what could become a booming business: helping clients profit from Sarbanes-Oxley.

Companies, feeling overburdened by the mushrooming costs of compliance, appear to be biting. But the new form of consulting work raises the possibility of auditor conflicts. The final four auditing firms - Deloitte & Touche, Ernst & Young, KPMG and PricewaterhouseCoopers - are approaching the new line of business quietly, aiming to steer clear of such issues.

"For the six largest accounting firms this is a number one growth strategy for immediate revenue."

-Alan Koltin, Practice Development Institute

The costs of Sarbanes-Oxley compliance is expected to be around \$5.5 billion in aggregate for U.S. companies in 2004, and rising, according to recent data from AMR Research, a software market research firm. There are no estimates yet as to whether companies will recoup any of the billowing costs associated with compliance, but audit firms are trying hard to sell them on the idea.

In particular, audit firms are looking at one of the most expensive regulations, section 404, which calls for companies to attest to the nebulous set of checks and balances known as "internal controls," and have audit firms sign off on the company's attestation. After extending a June deadline, the SEC now requires compliance with section 404 in annual reports ending on or after Nov. 15.

"For the six largest accounting firms this is a number one growth strategy for immediate revenue," said Alan Koltin, head of the Practice Development Institute, which consults for audit firms.

In addition to the big four, he said BDO Seidman LLP and Grant Thornton LLP are engaged in "a race to get their brand in front of the companies they don't audit to" as leaders in this area. Most auditors see a narrow window of opportunity, as companies strive to come up to speed quickly on compliance issues.

But auditors aren't being particularly outspoken about their new initiatives. No press releases have heralded the thrust.

Robert Guido, vice chair in charge of audit practices at Ernst & Young, said the company talks about the issue in general with clients, many of who seem to be interested in whether or not they can get more benefits out of compliance. But Ernst & Young said it doesn't have a specific business strategy on the issue overall.

PriceWaterhouseCoopers said it is doing this kind of consulting work for "hundreds" of non-audit clients globally.

"This is a huge part of our practice," said Dan DiFilippo, leader of Governance, Risk and Compliance at PricewaterhouseCoopers, adding that conversations about "extracting value" from compliance have come just in the last six to nine months.

"We see some clients who have already gone through the process and looking at the significant amount of money spent doing this, and others who are still struggling with 404 readiness," DiFilippo said.

KPMG said it is already doing a considerable amount of work in the area it calls "controls transformation," particularly in the oil and gas industry.

And while KPMG also sees many clients still struggling with the implementation phase of compliance, Steve Hill, a partner in charge of the audit and risk advisory services practice, said the firm briefs many clients on the long-term prospect of seeing better profitability as a result of compliance, something he said "gives them a lot of energy" during usually dour briefings on compliance topics.

"Compliance is not the endgame," according to a glossy excerpt from an upcoming Deloitte & Touche publication on Sarbanes-Oxley. Tom Schiro, Deputy Managing Partner for Deloitte's Audit and Enterprise Risk Services, also touted the idea at governance publication Compliance Week's recent New York conference.

"Wholeheartedly embracing the law can be less expensive than begrudgingly accepting it," is what Schiro calls the "Sarbanes-Oxley paradox."

All the audit firms were vague about how exactly compliance would help clients save money. Most emphasized the simplification that would come with an overhaul of operations, as well as minimization of risks associated with sloppy internal controls. Schiro also cited software consolidation as a money saver. Deloitte & Touche has already worked with one pharmaceutical company that had seven different software systems for ERP, or enterprise resource planning. The firm decided that rather than testing internal controls for all seven systems, they would just consolidate, a move Schiro believes will help them in the long run.

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Tax Shelter Probes Could Imperil Auditors' Independence

By Tiffany Kary

The recent, strange disclosure of a Securities and Exchange Commission probe into KPMG's current audit work for MCI - due to a decade-old tax shelter it sold the telecom company formerly known as Worldcom - has raised a new corporate governance specter: auditors could be found lacking in independence due to past consulting work.

Corporate watchdogs and large investors have already come down hard on conflicts that arise when auditors combine audit and non-audit work such as consulting or tax services. Calpers recently withheld votes from audit committees at 90% of its holdings for approving non-audit work by external auditors, a move it says jeopardizes the auditors' independence. But those decisions were made on concurrent conflicts alone.

The SEC's questioning of KPMG's status as an independent auditor points towards the possibility of other such conflicts. With the IRS sending out deep feelers in search of abusive tax shelters used even years ago, and many individual states looking to close loopholes, chances are that many more shelters like those KPMG sold to MCI will be unearthed. KPMG was also found to have sold an aggressive strategy known as CLAS to 29 companies including MCI, some of which currently use the firm as their independent auditor.

Considering tax consulting and auditing are dominated by what are known as the "final four" accounting firms, which are required to rotate lead audit partners with clients every five years, conflicts are bound to arise.

The SEC probe into MCI's relationship with KPMG slipped out accidentally. Documents on Piper Rudnick's billings showed the firm was being retained to represent MCI in a request from the SEC for information about MCI's "retention of KPMG as its independent auditor."

The papers were lying around MCI's bankruptcy proceedings until they suddenly attracted attention. The judge presiding in MCI's current bankruptcy proceedings complied with an MCI request to seal them.

Less than a week later, following an article in *The Wall Street Journal* which detailed the documents, the judge lifted the seal, saying the material had already been disseminated.

The controversy revolves around a tax shelter KPMG sold Worldcom in the 1990s, which allowed it treat the "foresight of top management" as an asset

valued at billions which it licensed to its various business units. The arrangement is the subject of a lawsuit by 14 states led by Massachusetts. In January, MCI's bankruptcy examiner suggested the company could sue KPMG over its state-tax advice. MCI didn't take the recommendation, and its relationship with KPMG has been in question ever since.

"There is a mutuality of benefit here. KPMG has an incentive to argue that the tax shelter is a legitimate one, and MCI would also benefit from such a ruling. So how can KPMG be an objective auditor?" said Itzhak Sharav, a Columbia University accounting professor.

Sharav noted that the treatment of management's prognostications as an asset is a unique and particularly "outlandish" tax shelter. "Obviously this is an abusive tax shelter. It has one reason and one reason only," he said.

MCI said it still considers KPMG an independent auditor, and KPMG declined to comment.

The Securities and Exchange Commission also declined to comment on the probe, as is customary, and a spokesman said he couldn't comment on whether the SEC is investigating other auditor-client relationships as a result of similar conflicts arising from tax consulting work.

But as states and the IRS expand their look at past tax shelters, experts say other conflicts are bound to arise.

"In Massachusetts, we've been trying to close corporate tax loopholes over the past couple of years," said a spokesman from the Massachusetts Department of Revenue. "We're not necessarily looking at auditing firms and their clients, but every time we find something in an audit we want to see if it's an industry-wide practice," he added.

"I wouldn't be surprised if the SEC is looking at auditor independence on a broader basis as it relates to tax shelters. Their budget and manpower are so much greater now," said Sharav.

Ernst & Young is the subject of a criminal investigation into promotions of potentially abusive tax shelters which was announced this May, on the heels of the probe into KPMG's shelters, which was announced in February. The IRS has been looking closely at past shelters for at least the past year.

One shelter commonly used by KPMG, known as CLAS, or "contested liability acceleration strategy,"

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Tiny Texas Fund Just Says No To Massive CEO Pay Packages

By Judith Burns

Jumbo executive pay doesn't impress this Texas mutual fund manager: In fact, Don Hodges is so disgusted with overpaid CEOs he's decided the \$50 million Hodges Fund he co-manages with his son Craig will not invest in companies that lavish excessive pay and perks on executives.

"It's morally wrong," Hodges said.

Cendant Corp. and Walt Disney Co. are "two of the worst" when it comes to heaping undeserved rewards on executives, according to Hodges. The Hodges Fund doesn't hold shares in either company.

Hodges' views were put to the test when former E*Trade Group Inc. Chairman and CEO Christos Cotsakos received \$80 million of compensation in 2001, when the online brokerage company lost more than \$240 million.

Since the tiny Hodges Fund had a hefty stake in E*Trade, Hodges wrote a blistering letter to Cotsakos - with copies to E*Trade's board of directors - protesting the "unconscionable" payments.

"I told him I had more respect for a bandit who would go and rob a 7-Eleven Store," said Hodges. Cotsakos resigned in 2003 and agreed to return more than \$20 million. E*Trade remains a top holding for the Hodges Fund.

Merrill Lynch & Co. Chairman and Chief Executive Stanley O'Neal doesn't get much respect from Hodges, either. He questions why O'Neal took \$28 million last year while handing out pink slips to thousands of employees. He's also critical of Citigroup Inc. Chairman and former Chief Executive Sanford Weill for accepting nearly \$1 billion in salary, bonuses, stock options and other benefits over 10 years.

Former New York Stock Exchange Chairman Richard Grasso's nearly \$200 million deferred compensation package represents more outrageous excess, in Hodges' view. He finds a \$5 million bonus to Grasso for opening the exchange after the Sept. 11, 2001, terrorist attacks particularly galling, and says Grasso should be "ashamed of taking it."

Grasso stepped down last year and faces a lawsuit filed by New York Attorney General Eliot Spitzer seeking the return of some of the \$139.5 million he has already received.

A few companies have drawn the line on sky-high pay. Hodges points to Whole Foods Market Inc. Chairman and Chief Executive John Mackey, who received \$367,000 in salary and bonuses in 2003, down from \$947,000 in 2002.

Richard Kinder, chairman and CEO of Kinder Morgan Inc., Kinder Morgan Energy Partners LP and Kinder Morgan Management LLC, who took home just \$1 in pay last year, gets Hodges' approval as well. Kinder owns nearly 20% of the Houston gas and

pipeline company and will do well if the stock does well, said Hodges.

The Dallas-based Hodges Fund currently doesn't hold shares of Whole Foods or Kinder Morgan. Its hard line on pay didn't hurt performance last year: The fund posted an 80% gain. It was up a less sizzling 6.76% in the first quarter of 2004.

Hodges tries to practice what he preaches on compensation. He said he and his son will draw annual salaries of \$60,000 and \$30,000, respectively, starting this month, their first direct pay from the fund since it started in 1992. Their management company receives an 85 basis point fund advisory fee and Hodges is president of First Dallas Securities Inc., an affiliated brokerage firm that received \$52,500 in commissions from the Hodges Fund in the most recent year.

Hodges Fund holdings include DocuCorp International, Inc., Helen of Troy Corp., Krispy Kreme Doughnuts Inc. and Luby's Inc. Hodges said its stake in Weight Watchers International Inc. offers a hedge if restaurants are hurt by dieting fads.

Supersized executive pay should be put on a diet, though, suggests Hodges, who thinks it tips the scales compared with past levels.

Compensation for CEOs in 1983 was about 40 times that of average employees, but ballooned to several hundred times employee pay by 2002, Hodges noted. And, he said CEO pay far outstrips salaries for top officials such as President George W. Bush, who pulls down \$400,000 a year, Federal Reserve Board Chairman Alan Greenspan, who earns \$171,900, and Securities and Exchange Commission Chairman William Donaldson, who is paid \$145,600.

Stock options have fueled a lot of the gains for corporate executives and Hodges concedes they sprang from a well-intentioned goal of aligning CEOs' interests with shareholders. Unfortunately, he said, "a lot of those guys are exercising those options as soon as they can, it's just become a salary substitute."

Luxury housing and other perks just compound the problem, adds Hodges. "If the company pays all your expenses, you don't really need a salary," he comments.

While he doesn't think Congress should step in, Hodges welcomes jawboning by SEC Chairman Donaldson and hopes corporate directors and compensation experts heed Donaldson's advice on rethinking executive compensation. He'd also like investors to pressure companies to reject bloated compensation packages for executives, both on moral and financial grounds.

Said Hodges: "A lot of shareholders don't stop to think that's coming right out their pocket."

US House Panel Told Of Need For US-EU Acctg Convergence

By Phil McCarty

Several financial experts told a U.S. House panel last week that convergence in accounting standards between the U.S. and the European Union is the most important issue facing capital markets in both regions.

"Accounting equivalency will be extremely important in attracting capital for U.S. firms," Richard Thornburgh, chairman of the Securities Industry Association and the chief risk officer at Credit Suisse Group, told the House Financial Services Subcommittee on Domestic and International Monetary Policy, Trade and Technology.

Hal Scott, professor of international financial systems at Harvard Law School, said the most "noteworthy shortcoming" of the dialogue between U.S. and EU regulators is the failure to resolve accounting equivalency issues. Scott said this could become a problem in 2005 when the EU adopts international accounting standards.

Under Securities and Exchange Commission regulations, foreign firms may only issue securities or list on U.S. exchanges if they conform to U.S. generally accepted accounting principals.

"Absent a change in SEC policy, EU firms which state their accounts in IAS will be unable to access the U.S. public market," Scott said.

"This could lead the EU to take the position that U.S. firms could no longer use U.S. GAAP in the EU market ..., having a severe effect on U.S. firms issuing capital abroad and further (increasing) the segmentation between the markets," Scott added.

Opponents have said that U.S. GAAP does a better job of protecting investors, but that argument has lost much of its credibility after investors have been rocked by major accounting scandals over the past several years.

"There is no evidence that U.S. GAAP is a better accounting standard than IAS," Scott said.

Paul Oldshue, representing the Bankers' Association for Finance and Trade, said the group generally supports the efforts to harmonize accounting standards, but called for the process to be more transparent and for a balanced approach between principle-based standards and rule-based standards.

Oldshue said the International Accounting Standards Board has decided that future standards will be written using a principle-based approach.

"Without sufficient detail, much of implementation guidance will be provided by individual

accountants, accounting firms or securities regulators, and their interpretations will likely result in varying applications of the rules," Oldshue warned.

All three agreed that the accounting issue needs to be resolved soon and asked that Congress help out in any way possible.

*in*BRIEF

ISS Renews Support For WellPoint-Anthem Deal

In a setback for the California Public Employees' Retirement System's campaign to derail Anthem Inc.'s acquisition of WellPoint Health Networks Inc., Institutional Shareholder Services has reaffirmed its support for the merger.

Calpers and State Treasurer Phil Angelides had urged the influential Rockville, Md., proxy adviser to reconsider its recommendation of the deal in the wake of the release of new documents that showed that executives would be awarded what they called "egregiously unwarranted pay."

The California officials pressed their case at a news conference earlier this week, in which Calpers board president Sean Harrigan announced the fund would cast its shares against the merger, citing potential executive payouts of as much as \$600 million. Calpers, the nation's largest public pension fund, owns 721,840 shares of WellPoint and 612,938 shares of Anthem as part of its indexed stock holdings.

But in its new analysis, circulated Thursday, ISS indicated that the figure likely overstated the actual cost to shareholders resulting from the marriage of the two health insurance concerns, even taking the newly released documents into account.

For example, the information, which was part of a filing made to California's Department of Managed Health Care, showed that payments to 293 WellPoint executives could range from \$147.2 million to \$356.3 million in cash, the former amount reflecting bonuses that would apply if all participants stayed with the merged entity, and the latter applying in the event of an involuntary or "constructive" termination within three years.

ISS analysts noted that WellPoint and Anthem executives have made public statements that they don't intend to terminate all the covered executives. "WellPoint's estimate of \$200 million appears to be a more reasonable and accurate representation of the most likely aggregate payout," ISS said in its report. Also, much of the merger payout relates to compensation packages that were in place or built up before the deal was signed, according to the report.

ISS also noted that the filing, which was obtained through a public records act request by the Foundation for Taxpayer & Consumer Rights, disclosed that covered executives may be entitled to \$251.2 million in stock options that would accelerate upon termination, a figure included in Calpers' calculations.

Not only are most executives expected to stay with the company, ISS said, but executives already own their options; because such options vest over a three-year period, it is "practically inevitable" that the options will become exercisable in the near future, regardless of the performance of the company.

ISS Scrambles To Tell Clients It Runs Conflict-Free Shop

By Phyllis Plitch

Institutional Shareholder Services is scrambling to assure investment advisers that it has procedures in place to defuse potential conflicts of interest related to its side business advising corporations.

ISS' offensive - a prominently placed statement on its Internet home page, a letter to investment clients and a Webcast seminar - comes in the wake of cautionary advice from the Securities and Exchange Commission that raised the specter of conflicts stemming from the firm's proxy recommendations.

While the SEC didn't single out ISS, the nation's most influential proxy adviser's clients are prime targets for the recently issued guidance because of the firm's dual business model.

As such, the Rockville, Md., firm is fielding an increasing number of queries from concerned clients about its corporate business since the SEC's investment management division's chief counsel wrote his May 27 letter addressing the issue. Responding to questions from Egan-Jones Proxy Services, the proxy service unit of Egan-Jones Ratings Co., the SEC's Douglas Scheidt wrote that investment advisers should first determine whether a proxy adviser can issue impartial recommendations, before relying on its advice.

"An investment adviser should establish and implement procedures to identify and address conflicts that can arise on an ongoing basis concerning the third party," Scheidt wrote, referring to the proxy firms. To that end, the investment manager should gather "any relevant facts" concerning a proxy adviser's relationship with a corporate issuer, such as how much compensation is being paid.

The "interpretive guidance," now posted on the SEC's Web site as guidance for the entire market, relates to an investment adviser rule enacted by the SEC last year.

That rule requires investment advisers to take steps to ensure that proxy votes are based on their clients' best interests and not be a "product of a conflict." Under the rule, one suggested path to compliance is to demonstrate that votes were cast "in accordance with a pre-determined policy, based upon the recommendations of an independent third party."

The rule's enactment followed a controversy that erupted after shareholders approved Hewlett-Packard Co.'s 2002 merger with Compaq Computer Corp. Deutsche Bank, through its investment banking division, had been retained to advise H-P on the proposed merger. The bank's asset management unit switched its 17 million votes after Deutsche bankers intervened on H-P's behalf.

Without admitting or denying the SEC's findings, the asset management arm paid \$750,000 to settle charges that it failed to disclose a material conflict of interest in its voting of client proxies.

ISS has been the subject of increased scrutiny in recent years. While its main business is offering voting advice on annual meetings and other corporate issues, such as approval of mergers, the firm also offers advisory and consulting services to the companies whose shares are being voted.

In its recent communications with investors, ISS said it has already taken steps to avoid conflicts of interest, including setting up so-called Chinese walls between researchers and the staffers who deal with corporate services.

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*in*BRIEF

PwC Quit Auditing Glimcher Due To Distrust In CEO

In an unusual move by an auditor of a publicly traded company, PricewaterhouseCoopers has decided to drop Glimcher Realty Trust as its audit client because of a lack of trust in Glimcher's chairman and chief executive.

The real estate investment trust, based in Columbus, Ohio, announced PwC's resignation, effective June 1, in a filing a week ago with the Securities and Exchange Commission.

Glimcher didn't provide at the time specific reasons for the auditor change. But it did mention what the company calls "a non-material, unintentional related-party transaction" questioned by its PwC auditors.

In a follow-up report filed on Tuesday, the company included PwC's response letter to the SEC relating to its decision to quit.

The letter says PwC disagrees with Glimcher's description of the related-party transaction as "non-material" and "unintentional." It also implies that PwC cannot rely on the words of Herbert Glimcher, the chairman and CEO, as a result of issues raised by the transaction.

The deal, according to Glimcher's 2003 annual report filed in March, involves Ellen Glimcher, daughter of the company's CEO, who provided \$471,000 worth of funding to a third party for its purchase early last year of some land options from Glimcher Realty. Later, the company bought back the land options for a total of \$696,000.

However, not until February did Glimcher's audit committee become aware that the company had not disclosed the deal. The committee then hired independent counsel to look into the matter. Its finding: the non-disclosure "was not intentional and was based on a misinterpretation of what constitutes a related-party transaction."

A company representative didn't return phone calls seeking comment. Nor did Michael Petrecca, managing partner of PwC's Columbus office.

A Bogus 'Middle Ground' On Expensing

By Michael Rapoport

Listen to the opponents of expensing stock options and you might get the idea that Congress has come up with a grand compromise solution to resolve the contentious options-expensing debate.

A House committee approved a bill recently that would require companies to count as expenses only the options they grant to their top five executives - thereby overriding a proposal by accounting rulemakers to expense the options issued to all employees. The panel's action prompted Rick White, chairman of the anti-expensing International Employee Stock Options Coalition, to praise the bill in a statement as striking "a sensible and appropriate middle ground."

Mark Heesen, president of the National Venture Capital Association, another expensing opponent, voiced similar sentiments when he testified before a House panel in March that the bill "reflects a thoughtful and balanced approach" to options accounting.

Nonsense. This bill no more stakes out any "middle ground" than the Greeks did when they sacked Troy. And a look at the proxy statements of some of the biggest issuers of options proves it.

Figures in those proxy filings show that most of these companies give only a tiny percentage of all their options to their top five executives - as little as 2% or so in some cases. That means that the overwhelming majority of the options that the Financial Accounting Standards Board wants to expense would be exempt from expensing if the House bill becomes law.

This does validate a key contention of opponents - that it's rank-and-file employees who get most options, and who would be hurt if all options are expensed and companies are thus prompted to cut back on issuing them. But to say that the system contemplated by the House bill finds a "middle ground" or takes a "balanced approach" is disingenuous. This isn't about finding a compromise acceptable to both sides; it's about wrecking FASB's plan, and keeping in place the current system that allows companies to pay their employees with options without incurring a cost that would hurt their earnings.

"What it is, is a compromise in name only," said Jack Ciesielski, publisher of *The Analyst's Accounting Observer* and author of a recent study of options accounting at Standard & Poor's 500 companies. "It's just another way of getting zero (expenses) into the financial statements and pretending that 'we did something.'"

But Jeff Peck, a consultant to the IESOC, maintained that many companies do see expensing the top

five executives' options as a compromise, "because they do not believe any options reflect a cost to the company."

Companies already disclose in their proxy statements what percentage of all the options they issue go to each of their top five executives, and it's a simple enough matter to tote up those figures. The figures show that Intel Corp., for instance, awarded 2.4% of all its options in 2003 to its top executives. Intel's net income would have declined by \$991 million in 2003 if all its options had been expensed; if only the top five execs' options are expensed as opposed to all of them, the company would save most of that amount by which earnings otherwise would suffer.

Other major technology companies, the heaviest users of options, are similar. Cisco Systems Inc. issued only 3.1% of its options to its top five executives in fiscal 2003. At Dell Inc., the figure was 5.5%.

Some other companies give more to executives, but not all that much more. According to Ciesielski's study, 18.1% of options granted in 2003 by the companies in the S&P 500 were granted to the five top execs. Even on a broad basis, then, the vast majority of options would be exempt from expensing under the House proposal. Some compromise.

Expensing opponents say top-five expensing is an equitable way to target the issues that made expensing an issue in the first place: high, options-fueled executive compensation and the incentive it gave executives to manipulate earnings in order to boost their stock prices. "The bill is a nod to quite a few members of Congress who are concerned about executive compensation abuse," said Jennifer Dowling, vice president for federal policy and political advocacy at the National Venture Capital Association.

White said in an interview that the House bill "gets at the issue that most people are concerned about." While "it wouldn't satisfy the accounting purists ... it is a pretty good compromise," he said.

By contrast, "you do not solve the issue of excessive executive compensation when you simply move to expense everybody's options," said Bill Calder, an Intel spokesman. (A Dell spokesman had no comment; a Cisco spokeswoman couldn't be reached.)

But options expensing isn't only about alleviating corporate scandal or addressing high executive pay. It's also about truth and transparency in accounting, and having a company's earnings statement reflect its true cost of doing business - something this bill does little if anything to foster. An

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Records Policies... *(continued from page 1)*

Record retention isn't a new concern for public companies - standards for specific industries have been on the books for a while. SEC rule 17 a4 and 17 a3 lay out rules broker dealers must keep; CFR part 11 requires pharmaceutical companies to keep particular kinds of data on file; DOD 5015.2 governs the aerospace industry; and HIPAA, healthcare firms.

But the SEC's crackdown on Bank of America, as well as a recent \$25 million fine it served Lucent for an alleged failure to cooperate, has made good records keeping a higher priority. The SEC, which has been adding 800 new staff to its ranks over the past year, has widened the depth and scope of its probes, putting more companies at risk. Sarbanes-Oxley has also upped the ante for punishment by making it a federal crime to tamper with evidence in a regulatory investigation. Companies also face risks from class-action suits and any other type of lawsuit that requires them to produce digital evidence.

Paper Still Abounds

Many companies aren't up to speed with new technology. A recent survey from AMR Research, a software market research firm, showed 68% of companies are planning to increase their budget for records management in 2004.

"We thought we would see a certain amount of records management maturity. But there seems to be a discrepancy between the IT department's feeling of preparedness and the legal departments'," observed Jim Murphy, senior analyst at AMR.

Iron Mountain Inc., a 53-year old company with its roots in paper document storage, said that of its 200,000 customers, only 100 use its new digital archiving product, which was launched in 2001. "And most of those companies are in financial services," said spokeswoman Melissa Burman, who estimates that over 80% of revenue still comes from its paper records business.

But 93% of corporate documents are now created electronically, and 70% of those documents are never printed on paper, according to statistics cited by Tanenbaum.

New Technology Poses Risk

Digitalization of once-ephemeral communications such as phone conversations and voice-mail is coming from new technologies such as voice over IP. This comes on top of increasing use of e-mail, corporate intranets, cell phones, instant messaging and PDAs, digital records of which are all created and stored. Data is also being duplicated at a faster rate due to outsourcing, which creates at least one extra set of information about the core company's business.

The end result is a lot of garbage data, which can end up making it hard for a company to cooperate with investigations even when it's trying to. The cost doesn't just come in risks associated with SEC fines for non-cooperation. The price of producing records ends up being around 25 cents a page for most companies, according to a study done by Deidre Paknad, chief executive of PSS Systems, a software company with a minimalistic, control-based approach to records management.

Paknad, also a founder of the Compliance, Governance & Oversight Council, noted that those costs end up hurting shareholders. By establishing a policy on record deletion, and a technological means to enforce it, companies can boast better governance standards, and also protect themselves from liability associated with individuals who either save too much information, or try to delete incriminating e-mail.

PSS's software sits on each desktop in a company, and applies and regularly expunges pre-selected files, overriding any one employee's own e-mail retention habits, something Paknad said is essential in protecting both the employees' and the company's liability. The company tailors its product for particular industries and inter-company departments. For example, financial services firms may need to keep e-mail correspondence for a longer time than an industrial manufacturer; likewise, the same company's legal department may need to keep phone records for longer than its marketing department.

PSS is one of many software companies offering compliance-related services; others include OpenPages, Movaris, and Nth Orbit. Products from Authentica, Liquid Machines, and Microsoft Corp. also deal with records control and document rights management.

Aside from saving companies a time-consuming, money-burning, laborious "e-discovery" processes should regulators come knocking, PSS's use of an auto-delete policy also helps companies avoid "spoliation claims."

Such claims, which charge that a company has violated its duty to preserve evidence, have become increasingly common. A company can be found guilty of spoliation even through inadvertent destruction - if data is deleted ahead of schedule, or a tape is accidentally written over, he adds. Only a hard and fast policy can protect a company.

And considering the lengths to which claimants will go in order to win a case, no one is safe against such claims unless they have a well-articulated records management system in place.

"Plaintiffs will even request a very broad set of data in the hopes of creating a spoliation claim," said Tanenbaum.

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.

Tax Shelter Probes... *(continued from page 8)*

was declared abusive by the IRS in November 2003 but was only recently revealed to be in widespread use. The IRS has said the shelter saved 29 large KPMG clients around \$1.7 billion in taxes.

Among clients known to have bought the strategy through KPMG's consulting work, Tenet Healthcare Corp., AstraZeneca PLC, Fresenius Medical Care AG, Qwest Communications International Inc., Cemex SA and Siemens AG currently use KPMG as an external auditor. AstraZeneca said it reviews all engagements with KPMG on an ongoing basis in accordance with its corporate governance policies. Fresenius said its audit committee had reviewed the matter. Tenet Healthcare said it couldn't comment on the matter, and other companies didn't return calls in time for comment, but recently declined comment to

The Wall Street Journal, which is also published by Dow Jones & Co., on a similar story.

Though many of the tax shelters being uncovered were used long ago, consultants advise companies to be proactive on dealing with any current conflict.

"These are the sins of the past within the structure of the present," said Alan Koltin, head of Practice Development Institute, a firm which consults for auditors.

Koltin noted that though aggressive tax shelters are likely to be uncovered as regulators dig deep, the past nature of many of the practices may help companies stay out of hot water if they act quickly. "Companies shouldn't wait until it is reported that your independent auditor had sold you a tax shelter. I would issue a press release, be proactive and say this is what we did in the past, but this is how it is today."

ISS Scrambles... *(continued from page 11)*

"Long before the SEC's recent letter, ISS had proactively implemented policies and procedures designed to ensure the integrity of our institutional proxy advisory service and to give our institutional investor clients the confidence they require to entrust their proxy voting requirements to ISS," the firm's CEO, John M. Connolly, wrote in the client letter.

ISS is also emphasizing that it will supply any information investment clients want about business ties with companies, information some investors have sought in light of the new guidance.

According to ISS Chief Legal Officer Steven Friedman, the firm has heard from about 10 clients inquiring about business relationships. Though a tiny percentage of its 850 clients, roughly 300 of whom must comply with the rule, ISS "has seen an increased inflow of requests since the guidance," Friedman said. Also, more than 60 investment advisers tuned into the

recent Webcast seminar discussing the rule's ramifications.

Ultimately, Friedman acknowledged, "investment advisers are making their own determination," about whether a conflict exists in any given situation.

One of ISS' rivals, Glass Lewis & Co., sees the SEC's letter as bolstering its view of how a proxy advisory firm should operate. The San Francisco proxy adviser stresses to clients that it "assiduously" avoids any possibility of conflict by advising only investors and by offering no services to companies.

Glass Lewis CEO and co-founder Gregory Taxin noted that ISS is presently not disclosing its relationships with individual companies in its research reports and is instead asking clients to contact the firm for further information. "What they are doing is begging the indulgence of their clients," he said. "They're imposing a burden on their clients so they can continue in their inherently conflicted business model."

'Middle Ground'... *(continued from page 12)*

option is an option is an option, whether it's issued to an entry-level minion or the CEO - and expensing one but not the other doesn't exactly promote good, consistent financial reporting.

"I just think it's a fundamental mistake for Congress to get in the business of setting accounting standards," said Robert Denham, chairman of the Financial Accounting Foundation, which oversees FASB and selects its members. "This kind of issue is really better left to the experts than to try to resolve through a political compromise process."

And all this is before we consider the other

restrictions on expensing the bill would impose: no expensing for small companies, no expensing for newly public companies in the first three years after their initial public offering, and no broad-based expensing until an economic-impact study is done, within a year after the bill is past. That tips the balance even further in favor of the anti-expensing forces.

The lack of options expensing has been an open sore for a decade now, and it needs to be resolved. But the bill now pending in the House isn't a real compromise, if such a thing even exists on this issue. And calling it one doesn't make it so.

GOVERNANCE ANALYSIS: REAL ESTATE INDUSTRY

This issue's chart compares the governance of the real estate industry with that of forty-eight other industry groups across the Russell 3000. Differences are highlighted in five different categories below. Data for the chart was provided by Institutional Shareholder Services, Inc.

<u>CGQ Rating Criteria</u>	<u>All Industries %</u>	<u>Real Estate %</u>
BOARD AND COMMITTEE ISSUES		
Board controlled by more than 75 percent independent outsiders	34.8%	23.4%
Nominating committee comprised solely of independent outsiders	50.7%	65.4%
Compensation committee comprised solely of independent outsiders	70.7%	75.2%
Audit committee comprised solely of independent outsiders	81.0%	86.0%
Governance committee exists	56.0%	76.6%
Chairman and CEO are separated	47.9%	47.7%
CHARTER, BYLAW AND ANTI-TAKEOVER ISSUES		
Classified board	54.1%	56.5%
Shareholders have cumulative voting rights	8.1%	6.1%
Governance guidelines are publicly disclosed	39.3%	65.9%
Majority vote requirement to amend charter/bylaws	44.5%	40.2%
Majority vote requirement to approve mergers	62.1%	66.4%
Shareholders may act by written consent	22.6%	17.8%
Shareholders can only act by unanimous written consent	33.8%	50.0%
Shareholders may call special meetings	42.2%	70.1%
Dual class capital structure with unequal voting rights	6.3%	3.7%
Company has no pill	23.0%	54.7%
COMPENSATION AND OWNERSHIP ISSUES		
Directors with more than one year of service own stock	88.8%	85.0%
Dilutions from options deemed excessive	25.6%	10.3%
Stock-incentive plans adopted without shareholder approval	18.5%	9.8%
Executives are subject to stock ownership guidelines	10.9%	11.7%
Directors are subject to stock ownership guidelines	12.1%	15.4%
Option grants align with company performance	56.3%	92.1%
PROGRESSIVE GOVERNANCE ISSUES		
Performance of the board is reviewed regularly	45.9%	67.3%
Outside directors meet without the CEO	41.6%	66.4%
Board approved succession plan in place for the CEO	30.6%	52.3%
Board has the express authority to hire its own advisors	81.4%	88.8%
AUDIT-RELATED ISSUES		
Policy disclosed regarding auditor rotation	31.6%	48.1%
Auditors ratified at most recent annual meeting	62.8%	56.5%
Fees paid to auditors are strictly audit fees	18.8%	25.2%
Non-audit fees are less than audit fees	76.3%	72.9%

AUDITOR CHANGES

This information is taken from regulatory filings and public statements issued by the companies in the last week. Unless otherwise specified, the companies said they had no disagreements with their former auditors, and the former auditors' reports on the companies' financial statements contained no adverse opinion or disclaimer of opinion.

Company: IGI Inc.
Hired: Amper, Politziner & Mattia
Replaced: KPMG LLP
Reported: June 21

Company: Ipix Corp.
Hired: Armanino McKenna LLP
Replaced: PricewaterhouseCoopers LLP
Reported: June 21

Company: Applied Materials Inc.
Hired: KPMG LLP
Replaced: PricewaterhouseCoopers LLP
Reported: June 18

Company: Horizon Offshore Inc.
Resigned: PricewaterhouseCoopers LLP
Reported: June 18

Company: Syntel Inc.
Resigned: Ernst & Young LLP
Reported: June 18

Company: Rubio's Restaurants
Hired: KPMG LLP
Replaced: Deloitte & Touche LLP
Reported: June 17

Company: Merrimac Industries Inc.
Hired: Grant Thornton LLP
Replaced: Ernst & Young LLP
Reported: June 17

Company: Intellectual Technology Inc.
Resigned: Comiskey & Co.
Reported: June 17

Company: Troy Group Inc.
Hired: Corbin & Co.
Reported: June 16

Company: Actuate Corp.
Hired: KPMG LLP
Replaced: Ernst & Young LLP
Reported: June 16

Company: Datascope Corp.
Hired: BDO Seidman LLP
Replaced: Smolin Lupin & Co.
Reported: June 16

Company: National HealthCare Corp.
Resigned: Ernst & Young LLP
Reported: June 15

Company: American Vantage Cos.
Hired: Deloitte and Touche LLP
Replaced: Piercy, Bowler, Taylor and Kern
Reported: June 15

Company: National Rural Utilities
Cooperative Finance Corp.
Hired: Deloitte and Touche LLP
Reported: June 15

Company: Century Controls
International Inc.
Hired: Carver Moquist & Associates LLC
Replaced: Virchow Krause & Co.
Reported: June 14

Company: Verso Technologies
Hired: Grant Thornton LLP
Replaced: KPMG LLP
Reported: June 14

Company: Uroplasty Inc.
Resigned: KPMG LLP
Reported: June 14

Company: Optical Sensors Inc.
Hired: Virchow, Krause & Co.
Replaced: Ernst & Young LLP
Reported: June 14

Company: Superior Uniform Group Inc.
Hired: Grant Thornton LLP
Replaced: Deloitte & Touche LLP
Reported: June 14

Company: Surgilight Inc.
Hired: Richard L. Brown & Co. PA
Replaced: Moore Stephens Lovelace PA
Reported: June 14

Company: Milestone Scientific Inc.
Hired: Eisner LLP
Replaced: J.H. Cohn LLP
Reported: June 10

Company: Tomahawk Industries Inc.
Hired: Russell Bedford Stefanou
Mirchandani LLP
Replaced: S.W. Hatfield CPA
Reported: June 10

Company: Worthington Industries Inc.
Hired: KPMG LLP
Resigned: PricewaterhouseCoopers LLP
Note: PwC resigned as auditor of Worthington's deferred profit-sharing plan, the company said in a Form 8-K filed with the Securities and Exchange Commission.
Reported: June 10

Company: Navigant International Inc.
Hired: Deloitte & Touche LLP
Replaced: PricewaterhouseCoopers LLP
Reported: June 10

Company: Oryx Technology Corp.
Resigned: PricewaterhouseCoopers LLP
Reported: June 10

Company: Enhance Biotech Inc.
Hired: Cacciamatta Accountancy Corp.
Replaced: Farber & Hass LLP
Reported: June 9

Company: Glimcher Realty Trust
Resigned: PricewaterhouseCoopers LLP
Note: As a result of a previously disclosed "non-material unintentional related party transaction" concerning the company's City Park development project, PwC requested and the company agreed to a change in Glimcher Realty officers that would execute representation letters to the auditor.
Reported: June 9

Company: Gensym Corp.
Hired: Vitale Caturano & Co.
Resigned: PricewaterhouseCoopers LLP
Reported: June 9

Company: Alico Inc.
Hired: Tedder, James, Worden
& Associates
Replaced: KPMG LLP
Reported: June 8

Company: Insightful Corp.
Resigned: Ernst & Young LLP
Reported: June 8

Company: Legend International
Holdings Inc.
Hired: Child Sullivan & Co.
Replaced: Clyde Bailey P.C.
Reported: June 8

Company: Environmental Power Corp.
Hired: Vitale, Caturano & Company PC
Replaced: Deloitte & Touche LLP
Reported: June 7

Company: Scientific Technologies Inc.
Hired: BBO Seidman LLP
Replaced: PricewaterhouseCoopers LLP
Note: The company cited cost concerns in making its decision.
Reported: June 7

Company: Comprehensive Care Corp.
Hired: Kirkland, Russ, Murphy & Tapp
Replaced: Eisner LLP
Reported: June 7

NEW AND DEPARTING EXECUTIVES AND DIRECTORS

<u>Company</u>	<u>Name</u>	<u>Action</u>	<u>News</u>
Aetna	R. David Yost	Resigns from Board	Yost is CEO at AmerisourceBergen.
Apple	Fred D. Anderson	Joins Board	
Best Buy Co.	Mark C. Thompson	Resigns from Board	Thompson resigned due to a conflict of interest involving an arrangement to provide services to Best Buy's independent auditor, Ernst & Young.
EDS	Edward Kangas	Joins Board	Kangas, 60, was Chmn & CEO at Deloitte Touche Tohmatsu.
Elan Corp.	Garo Armen	Resigns as Chmn	Armen is Chmn & CEO of Antigenics. He is leaving Elan after steering it through a two-year crisis.
Freddie Mac	Thomas Johnson	Joins Board	Johnson is Chmn & CEO at GreenPoint Financial.
General Electric Co.	Sir William Castell	Named Vice Chairman	Castell, 57, is also an executive officer and member of the GE Corporate Executive Office, as well as GE Healthcare president & CEO.
Kellogg Co.	Jeffrey W. Montie	Named President, Kellogg North America	Montie, 42, was president of Morning Foods North America.
Marriott International Inc.	Richard S. Braddock	Joins Board	Braddock is Chmn at MidOcean Partners.
Marriott International Inc.	Debra L. Lee	Joins Board	Lee is president & COO of Black Entertainment Television.
Midway Games Inc.	Kenneth Cron	Named Chmn	Cron, 47, is interim-CEO at Computer Associates International. He succeeds Neil Nicastro as Chmn.
Midway Games Inc.	Shari Redstone	Named Vice Chmn	Redstone, 50, is president of National Amusements.
Midway Games Inc.	Joseph Califano Jr.	Joins Board	Califano, 73, is president of the U.S. National Center on Addiction and Substance Abuse.
Midway Games Inc.	Neil Nicastro	Resigns as Chmn	
Sempra Energy	Donald E. Felsing	Named President & COO	Felsing, 56, will become CEO in Jan. 2006. He has also been elected to the board.
Sempra Energy	Neal E. Schmale	Joins Board	Schmale, 57, is EVP & CFO at Sempra Energy and is slated to become COO in Jan. 2006.
TeleTech Holdings Inc.	Mark C. Thompson	Resigns from Board	Thompson's relationship with Ernst & Young is under scrutiny by the SEC. He stepped down from TeleTech's board May 10.
Tenet Healthcare	James A. Unruh	Joins Board	Unruh, 63, is principal at Alerion Capital Group.
The Bear Stearns Companies Inc.	Wesley S. Williams	Joins Board	Williams is partner at the law firm of Covington & Burling and Co-Chmn, Co-CEO, president & COO of Lockhart Companies.
Whirlpool Corp.	Michael D. White	Joins Board	White, 52, was most recently chairman and chief executive of PepsiCo Inc.'s (PEP) PepsiCo International affiliate.