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Securities Exchange Commission
450 Fifth Street, NW,
Washington DC, 20549-0609

RE: Subcommittee on Smaller Companies File Number: 265-23

Dear Mr. Katz,

I would first like to applaud the committee for their efforts. I'd also like to compliment your transparency via the wonderful web casts and transcripts that enable outsides to join the discussion and contribute new ideas.

One idea gaining steam in the academic community that I believe you should consider for further review is the idea of an Earnings Quality Rating (EQR) or Assessment (EQA) score. As I will outline, you will find it uses market forces rather than regulation to improve accounting quality. It's modeled after the Credit Rating industry that has successfully improved management's responsibility with cash flow over the past 100 years. More importantly, it would bring a much higher benefit to cost ratio than Sarbanes-Oxley, especially for small companies. In addition to reduced chance of fraud, ancillary benefits include: provide investors better earnings comparisons, reward quality accounting, improved relations with auditors, and offset the decline in research coverage. While Sarbanes-Oxley has hurt the many due to the actions of a few, Earnings Ratings would benefit all.

Background

In the wake of the accounting scandals, Congress operated quickly to restore investor confidence with the passage of the Sarbanes-Oxley act, which aims to reduce the chance of fraud. However, even years before the scandals, investors began losing confidence in the earnings figures. Leaving aside instances of fraud, let's look at financial reporting from another standpoint – just general measurement of a company's financial condition.

One of the most important pieces of financial information of a company is its earnings figure. "The primary focus of financial reporting is information about earnings and its components."[1] "Earnings information is commonly the focus for assessing management's stewardship or accountability. Management, owners, and others

[1] *Statement of Financial Accounting Concepts No. 1,* Highlights, Financial Accounting Standards Board, Norwalk, CT, November 1978

emphasize enterprise performance or profitability in describing how management has discharged its stewardship accountability." [2]

This information is broadly relied upon. "Investors, creditors and others … may use earnings information to help them (a) evaluate management's performance, (b) estimate "earnings power" or other amounts they perceive as "representative" of long-term earnings ability of an enterprise, (c) predict future earnings, or (d) assess the risk of investing in or lending to an enterprise … Measures of earnings and information about earnings disclosed by financial reporting should, to the extent possible, be useful for those and similar uses and purposes." [3] And since investors assume that the earnings are correctly prepared in accordance with accounting guidance when there is an unqualified auditor's report, earnings are used to place a value on the business. The commonly used price-earnings (P-E) ratio provides the basis for comparisons of valuations between entities.

However, all earnings are not the same. The truth is that most of the numbers in every publicly traded company's financial statements are the product of lots of "estimates piled upon large doses of guesswork."[4] For any given transaction, there might be a wide variety of acceptable accounting principles to choose. The effects of applying different principles might result in great disparity, but nonetheless, if an acceptable method is chosen and properly applied the auditor has little choice but to accept the accounting.

Even the accounting profession realizes that the recognition judgments they make are primarily intended to increase reliability in the very long run, but may result in significantly different results when examined in yearly segments. "Earnings and its components relate to an individual enterprise during a particular period. Over the life of an enterprise (or other very long period), total reported earnings equals the net cash receipts excluding those from capital changes … but that relationship between earnings and cash flows rarely, if ever, holds for periods as short as a year …"[5]

In 2002, Standard & Poor's calculated what they considered to be "core earnings", or earnings associated with the operations of the business (thus excluding investment windfalls, adding stock option expenses, and other items). How big was the difference between core and reported? According to S&P, companies in the S&P 500-stock reported on average $26.74 earnings per share for the 12-months ending June 2002, but the core earnings were just $18.48, a 31% difference.

While Generally Accepted Accounting Principles adequately measure the value of an enterprise for a variety of purposes, it is clear investors need a better means for

[2] *Statement of Financial Accounting Concepts No. 1,* Paragraph 51, Financial Accounting Standards Board, Norwalk, CT, November 1978
[3] *Statement of Financial Accounting Concepts No. 1,* Paragraph 47, Financial Accounting Standards Board, Norwalk, CT, November 1978
[4] "Shock! The Numbers are merely Estimates", Jonathan Weil, Wall Street Journal, March 9, 2004, Page C1.
[5] *Statement of Financial Accounting Concepts No. 1,* Paragraph 46, Financial Accounting Standards Board, Norwalk, CT, November 1978

investment comparison and protection. We believe the credit rating provides such a model.

The Earnings Quality Rating

The concept of rating credit was pioneered by John Moody (founder of Moody's) in 1909. Moody's rating is expressed as a letter grade and provides an assessment of creditworthiness, implying the likelihood that debts would be repaid. Credit ratings now required in all sorts of legal document; bank loan covenants, money management agreements, and bank reserve requirements. If an issuer wants to access the institutional money market, they must maintain their credit rating. This market force governs companies to be conservative with cash flow management.

Now let's look at accrual accounting. The prudent investor will understand the business a company is in, the economics of the industry, current trends, econometric data and competitor moves and be able to assimilate the effects all of this will have on the company. Putting all this information in the model the investor uses should allow him (her) to make reasonable projections of a company's earnings. The investor deserves to see an actual earnings figure that is devoid from variation resulting from fluctuation caused by the choice of accounting principle.

In periods where prices are only going one way, the effect of accounting principle choice can be somewhat isolated and anticipated. However, in periods where prices fluctuate (the more common situation), choosing an accounting principle that does not mirror the way the company operates can result in earnings that run counter to intuition and expectation.

While not a requirement, it certainly seems to make common sense that a company uses those accounting principles that reflect their operations. When choosing an inventory costing method, companies may select from first-in, first-out (FIFO), last-in, first-out (LIFO) or weighted-average cost. Unfortunately since management is motivated to increase profits, the list of criteria the company uses to select an accounting principle is not always based on how the inventory actually flows, but instead includes such considerations to which methods tend to produce higher net income, lower taxes, or provide a stronger balance sheet. This is counter to transparent financial reporting. The physical flow of goods will generally match one accounting method better than the others, but there is no requirement to use the method that matches the best.

The Earnings Rating is therefore a rating system that assesses how well the accounting choices a company makes mirrors their operations will allow investors to make an assessment of the degree to which the earnings figure can be relied upon. It is a letter grade (A, B, C, D, and F) that provides investors guidance on how far the company's accounting differs from their actual operating practice. This letter grade is then translated into a percentage adjustment factor that should be applied (plus and minus) to the analyst/investor's best estimate of earnings.

Earnings ratings are not a new invention. For years investment companies have graded accounting policies, or at the very least made accounting the focus of their analysis. For 22 years, Ford Equity Research has been grading accounting policies in their equity analysis. Some rating agencies (and individuals) assess corporate earnings based on differing standards, such as whether the accounting policies are "aggressive" or "conservative," with the underlying implication that one is better than the other. By looking for accounting shenanigans, Howard Schilit was one of the first to tip investors to Enron's downfall through his Center for Financial Research and Analysis. Mellon Capital Management's, Ramu Thiagarajan, who was formally a professor of accounting at Kellogg School of Management, looks at Earnings Quality globally.

What is new that is being suggested here it to democratize earnings analysis allowing both big and small investors access, and using the resulting market forces to improve management's responsibility with accounting choices. Like credit ratings, issuers would pay for the Earnings Rating report thereby enabling the free distribution of the rating to all investors. The cost will most certainly be less than the $400,000 hard cost estimate of Sarbanes-Oxley 404 and not require as much management time. Like auditors, Earnings Ratings companies should have access to the company's books in order to conduct their analysis. Like the credit ratings, there should be an oligopoly of nationally recognized earnings evaluators. This establishes a consistent process investors can rely on and reference in agreements and covenants. It also prevents companies from shopping for good ratings.

Some may bring up the credit rating agencies also failed investors in the case of Enron. However, as Congress investigated the so-called "watch-dog" groups, the credit rating agencies testified they are not oriented to do audits. Earnings Ratings agencies would be specifically designed to do so thus closing the watch-dog gap.

Benefits

While the concept of Earnings Ratings is simple to understand, the benefits would be enormous and solve multiple problems experienced today.

- Reduce Chance of Fraud – Earnings Rating agencies would employ professional auditors, providing investors a second set of eyes on the company's books. This holds both management and their auditors accountable. As Joseph Stieven of Stifel Nicholas remarked, "there is a true extra set of eyes in the bank regulators." As a result, he "defied anyone to name five major bank failures [from accounting]."[6] Earnings ratings would bring this double check to all industries. While the SEC does perform this function for a sampling of companies, in reality resource constraints limited the SEC's ability to detect wrongdoing prior to the scandals. "To uncover such fraud requires a considerably more in-depth audit

[6] Securities & Exchange Commission Subcommittee on Smaller Public Companies, August 8, 2005, transcript page 160.

than the SEC has thus far been equipped or oriented to do."[7] And while the SEC has recently increased its staff, will the SEC continue to have this in their budget years from now when the fervor has died down?

- Restore Investor Confidence – Although Sarbanes-Oxley restored some investor confidence, suspicion still exists. According to Integrity Research Associates, a research consulting firm, one of the fast growing areas of equity research is forensic accounting[8]. Others feel Sarbanes-Oxley is more process than effective deterrent. As former SEC Chairman Richard Breeden warned, "three or four individuals, no matter how much talent and time they are willing to bring to the job, are not going to match the internal and external audit functions".[9] Clearly, a second set of eyes on the books will be more effective in restoring confidence than oversight. Furthermore, while Sarbanes-Oxley is a complicated law soon to be forgotten by the general public, the simple letter grade of Earnings Ratings would be available for free on every financial website and information service reminding everyone someone else is watching.

- Facilitate Investment Comparison – As mentioned previously, reported earnings do not provide figures to do an apples to apples business comparison, and yet price/earnings ratio is one of the most widely used methods for evaluate investments. Under the new system, investors could apply "*Earnings Rating* Factor"[10] to the reported earnings, thus equalizing the denominator. The new comparison formula would be Price / (Earnings * *Earnings Factor*™).

- Enhance Management Responsibility - Investors have long looked at credit ratings to "enhance management responsibility"[11]. In order to maintain a quality debt rating, management must manage cash flow closely. The same can be achieved with accounting. Companies currently have the right and responsibility to make the accounting choices. They, however, are motivated to increase profits, often in the short-term interest to the detriment of better, long-term decisions. Auditors determine whether their choices are acceptable or not according to Generally Accepted Accounting Principles. There is only 'yes' or 'no', there is no range of opinions. There is no indication of appropriateness. If the Earnings Rating existed, management would now know their accounting preferences would later be evaluated by an outside agency with a bent towards using the choice of accounting principle to accurately mirror the physical reality of the company's

[7] Financial Oversight of Enron: the SEC and Private-Sector Watchdogs, U.S. Securities and Exchange Commission, October 8, 2002, Page 40

[8] Investorside Independents Day Research Conference, April 13, 2005, New York, NY

[9] "Is Sarbanes-Oxley Working", The Wall Street Journal, June 21, 2004, Page R8

[10] The Earnings Rating Company would provide investors guidance on the Earnings Rating Factor". For instance, a B rating may mean investors should consider the reported earnings to be X% -Y% greater than "conservative accounting". This factor will ultimately be determined based on examining accounting policies of multiple firms within the SIC code and analyzing the resulting earnings curve.

[11] Report on the Role and Function of Credit Rating Agencies in the Operations of Securities Markets, US Securities and Exchange Commission, January 2003, Page 27

business While auditors must opine on legality in black or white, Earnings Ratings have a range of suitability options from which to chose.

- Provide CFO's Cover – According to CFO.com, 47% of America's CFO's still feel pressure from management on accounting issues. Suppose we give CFO's cover? Management could still chose to push accounting limits, however now they would risk the threat of an Earning Rating downgrade. An Earnings Rating, therefore, is a counter incentive that penalizes bad behavior and rewards conservative accounting.

- Reward Conservative/Transparent Accounting – Today companies that chose aggressive accounting policies are rewarded with higher earnings and thus a higher market capitalization. There is really no benefit for them to be conservative. On the other hand, how many companies would be proud to say their accounting is AAA rated especially if the majority of institutional investors were only allowed to invest in A rated companies?

- Restore the Relationship between Companies and their Advisors – As noted by many that testified, the relationship between auditors and companies has become adversarial to the point where value advice is being withheld due to "paranoia". Establishing an Earnings Rating agency structure would allow audit firms to return to their role as "good cop."

- Improve Information Flow to Institutional Investors – Several members of your subcommittee expressed concerns about the decline of analyst coverage. This problem will get worse as the two major sources for research revenue have (or are being) eliminated (investment banking and declining trading commissions). There are many definitions of earnings quality, but all of them include an examination of current earnings streams, thus providing institutional investors valuable information in order to make their own projections. Earnings ratings would not make projections into the future like an analyst report, but according to Integrity Research the trend in equity research is moving away from these projections anyway as more analysts do their own estimates.

In Conclusion

In short, an Earning Rating would be an effective measure that uses market forces to encourage conservative accounting while constantly reminding the public accounting is being scrutinized. It would correct the shortfalls in our financial systems (lack of double accounting check or conservative incentive) that directly lead to the accounting scandals, and would right a gross misconception in equity evaluation.

This comment is submitted on behalf of Mr. Richard Furlin and Dr. Jeffry Haber, CPA founders of EQ Metrics, LLP, an earnings rating company. Mr. Furlin is the former Sr.

Director of Analytic Content at Standard & Poor's, and Dr. Haber, is an Associate Professor of Accounting at Iona College.