October 8, 2007

Dear Mr. Pozen and Honorable Committee Members,

I would like to draw your attention to a simple idea that would dramatically improve audit quality, investor confidence and communications. As Arthur Levitt wrote in the book *Take on the Street*, "to stop the numbers game, Warren Buffet believes, and I agree, that corporate boards should require auditors to rate the aggressiveness of accounting policies." (This has been echoed by several academics.) However, going one step further, checks and balances will be enhanced if the analysis is conducted by a third party, instead of their auditors. Actually, this already exists today, and it's a $60 million business. But, by making it a regulatory requirement, the dynamics of this fast growing research service would dramatically change, and in its place would be a "rating agency" type structure leveraging market forces to improve accounting. As a former Sr. Director at Standard & Poor's, I have seen first hand how benchmarks can temper management's aggressiveness and increase the flow of information to the capital markets.

Earnings Quality Rating

Non-auditing, third party accounting examiners exist today. According to Integrity Research Associates, there are 19 companies currently sell earnings quality/forensic accounting research. They observe how conservative/aggressive management is in their application of accounting polices (choices within Generally Accepted Accounting Principles), while alerting investors to possible "shenanigans." Bought mostly by hedge funds, its primary value is identifying "red flags" or short opportunities.

This research <u>must</u> be democratized! By simply making it a listing requirement, researchers would change their business model from subscription (available only to wealthy investors), to "issuer paid" (available to everyone similar to financial statements). (Note: The credit rating industry transitioned to an issuer paid model when bank regulators mandated that only "high quality" bonds could satisfy reserve requirements). Earnings rating agencies would be hired by a company's Independent Audit Committee to ensure unprejudiced analysis. They'd issue letter grades (AAA, AA,… B,... D, etc) that would be freely distributed though the Internet to all investors. I'm sure Mr. Autoworker would like to know if there's a "D" rated company in his retirement account. Extensive research and tools would be sold to institutional investors.

It's true the credit rating agencies have come under fire recently, but as they say "you can't let perfection be the enemy of good." Image where the financial world would be today if investors didn't have easy access to corporate or municipal bond ratings?

Business Model Benefits

While the concept of an earnings ratings agency is simple, the benefits would be enormous:

• More Conservative Accounting - According to CFO.com, 47% of America's CFO's still feel pressure from management on accounting. After all, the more aggressive they are (without stepping over the line) the bigger their bonus will be. There's little downside. But the scandals occurred when previously good people influenced by fame and the seduction of stock option rewards crossed the narrow line they had been inching towards.

Earnings ratings are a necessary counter incentive that can easily be written into management compensation agreements, investment policy statements, loan convents, etc.. Their gradual grading method would keep managers far from the edge. Currently, management is free to choose their level of allowance for doubtful accounts, and it may be used to manipulate earnings. But would they if they if variation from previous levels risked a downgrade? This gives the CFO's cover.

It also gives auditors cover. According to many, their relationship with the companies has become adversarial to the point where valuable advice is being withheld due to "paranoia." By establishing an earnings rating agency structure it would allow audit firms to return to their role as "good cop."

Earnings ratings also provide upside for managers. How many chief executives would be anxious to have their conservative accounting recognized versus their aggressive peers?

• Ever-Present Watchdog - In the aftermath of the scandals, Congress sought to examine the breakdown of "watch-dog groups" including securities analysts, the Securities & Exchange Commission (SEC), and the credit rating agencies. The report concluded that none were fully equipped or oriented to serve that function.

Effectively, little has changed with these groups. Securities analysts have been separated from investment banking, but realistically their bonuses are still dependent upon the overall bonus pool, which ultimately is driven by investment banking profits. Credit agencies maintain their role is not auditing. The SEC did increase its staff to do more spot checks, but will they have the same budgets a few years from now when the scandals have faded from memory?

Initially, Congress pushed for mandatory auditor rotation. They reasoned accounting firms would be less likely to be seduced (e.g. Anderson audits of Enron) if the chance of discovery was greater. Industry pushed back citing the high costs, and congress instead

established the Public Company Accounting Oversight Board (PCAOB). Although they do quality control checks on auditors, the bottom line is that there still isn't a watch dog on every audit. But, as banking analyst Joseph Stieven of Stifel Nicholas observed on the SEC's Advisory Panel for Smaller Public Companies, "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]."

Can an accounting "watch-dog" be establish at a reasonable cost to issuers? Leave it to private enterprise. Credit rating agencies, which are granted special access to non-public information, charge issuers a reasonable fee, but earn revenues in multiple ways. Publishers are adept at repurposing the same information with varying depths for different markets. Earnings rating agencies can accomplish the same. The $60 million now paid by the buy-side can used to subsidize accounting investigation for all.

• Increase Information Flow – For individual investors, earnings rating agencies would broadcast their "seal of approval" through every financial distributor and website (e.g. Bloomberg, Reuters, Yahoo Finance, Google Finance, etc). It would be a daily reminder of the presence of another watch-dog. This availability and branding will truly restore investor confidence.

Institutional investors would be able to purchase accounting analysis like what is produced today, but for every listed company. Though it's no longer a short idea since everyone is aware, it does reduce the analyst's work. The first stage of equity research is accounting examination in order to establish a solid base for which to make projections. Since this same work is performed by every analyst researching a company, it is redundant (and generally outsourced to India today).

This solution is especially ideal for smaller public companies that have no Wall Street analyst coverage, which is a separate but critical problem in the capital markets. With the accounting investigation already completed, Wall Street analysts can increase the number of companies they cover. Perhaps they still won't cover the smallest companies, but the reports still provide a company a means to get their message to the institutional investor community since they contain an examination of current earnings streams, which is included in most all definitions of earnings quality.

• Facilitate Investment Comparison – Leaving aside fraud, let's look at accounting from a means to facilitate investment comparison. 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 <u>31%</u> difference. Clearly, with a 31% average variation in the denominator, the widely used price-to-earnings ratio has little true value.

Earnings ratings examiners look at the accounting policies and whether they mirror the operations of the business. Entities in similar businesses should have made similar accounting choices. Earnings ratings would put pressure on management to confirm to others in the industry and this will naturally narrow that gap.

In Conclusion

In short, earnings ratings would be an effective measure that uses market forces to encourage more conservative accounting while constantly reminding the public of another watch-dog. It would correct the shortfalls in our financial systems that directly led to the accounting scandals and would right a gross misconception in equity evaluation.

Sincerely,

Richard S. Furlin