

EASY MONEY – FOR EXECUTIVES, OR FOR SHAREHOLDERS?

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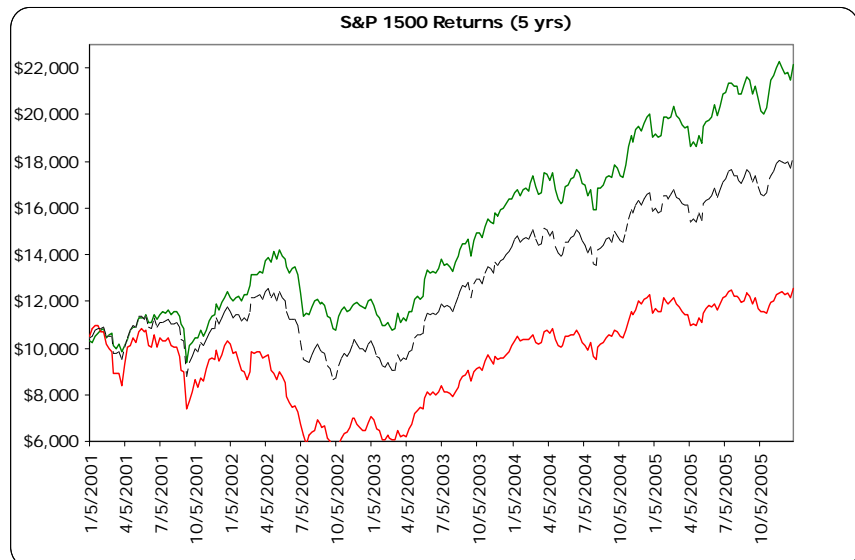
The press continues to hammer on malfeasance by corporate management. Although only a small percentage of public companies are guilty of these practices, their abuses range from excessive compensation, to the unethical (illegal) act of back-dating Options. In addition, we find in our research a number of other problems, including misinformation that disguises the company's fair value; damaging conflicts of interest between management and shareholders; unfunded pension liabilities; off-balance sheet leasing; and excessive insider selling coupled with company share repurchases.

In short, throwing a few executives behind bars will not subvert human nature.

The effect of the actions above is to line someone's pockets. That someone is usually the corporate executive, with company shareholders frequently paying the price. Our efforts at Audit Integrity help to uncover these accounting and governance problems using forensic analysis, since the companies that engage in misrepresentation work hard at hiding the evidence (see Appendix).

In order to appreciate the magnitude of the damage, I turn to the market itself. Using the Standard & Poor's 1500 Index (including big-, mid-, and small-cap companies) as a proxy for the market, we find some interesting results.

Model Score	Avg. Annual Return
1	7.7%
2	10.7%
3	13.7%
S&P 1500¹	13.4%
4	14.8%
5	17.4%
Annual Spread	9.8%



In each of these cases we assumed that the investor purchased \$10,000 of each of the three portfolios, starting at the beginning of 2001 and ending in 2005 (a five-year period).

The Model Score 5 portfolio consists of all S&P 1500 companies that have very transparent accounting, consistent management and methodology, and strong governance, as measured per Audit Integrity's Accounting & Governance Rating (AGR®). Model Score 5 companies represent approximately 15% of the total stock population measured by Audit Integrity, or 1,200 Companies.

The Model Score 1 portfolio consists of all S&P 1500 companies that have very opaque accounting, inconsistent management and methodology, and weak governance as measured by Audit Integrity's AGR®. Model Score 1 companies represent approximately 5% of the population, or 400 Companies.

As shown by the 13.4% annual return of the S&P 1500, the five-year period ending 2005 was characterized by high overall returns. In addition to an "up" market, there was even easier money to be made -- this time, by the shareholders, as opposed to the managers. By avoiding the additional risks associated with low-quality accounting and conflicted management, the investor could have avoided investments that returned 570 basis points per year less than the average return of the market. Conversely, an additional 400 basis points could have been generated annually by buying companies with good accounting provided by good management.

This 9.8% annual difference in returns between Model Score "1" and Model Score "5" is solely dependent on the quality of accounting and management, and completely independent from the fundamentals of the business. It looks to me like investors have a means to make "easy money" by avoiding company managers whose practices serve their personal interest at the shareholders' expense.

Will this "easy money" world continue into the future? We believe so, and are working hard to ensure Audit Integrity's forensic measures continue to provide investors with a reliable tool to separate the White Hats from the Black Hats.

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APPENDIX
FRAUD DETECTION METRICS

- No simple measure of fraud risk exists – a partial list is below
 - **Earnings Quality** models are limited to looking at accruals, a critical but limited risk measure
 - **Forensic Accounting** focuses on the reporting, but may miss other relevant measures of risky behavior
 - **Corporate Governance** ratings measure many “politically correct” behaviors that do not impact corporate performance
- In managing fraud-related risk, all measures must be looked at

Metric	Earnings Quality	Forensic Accounting	Corporate Governance
Receivables	x	x	
Inventory	x	x	
Deferred Charges	x	x	
Depreciation & Amortization	x	x	
Plant, Property & Equipment	x	x	
Accrued Expenses	x	x	
Payables	x	x	
Prepaid Expenses	x	x	
Reserves	x	x	
Operating Revenue (Operating Margin)		x	
Cost of Goods Sold (Gross Margin)		x	
Sales, General & Administrative		x	
Research & Development		x	
Goodwill		x	
Intangibles		x	
Asset Gains/Losses		x	
Operating Leases		x	
Pension Plan Accounting		x	
Compensation		x	x
Options		x	x
Equity Financing		x	x
Debt Financing		x	x
Share Repurchases		x	x
Auditor Change			x
Auditor Opinion			x
Amended Filings			x
Late Filings			x
Material Restatements			x
Board Composition			x
Board Performance			x
Related Party Transactions			x
Chairman/CEO Separation			x
Officer Turnover			x
Insider Trading			x
Stock Ownership			x
Merger & Acquisition Activity			x
Restructurings			x
Discontinued Operations			x