



“Tone at the Top”

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An article just published by KPMG’s Audit Committee Institute reinforces¹ our belief that setting the right tone is vital to the long-term stability of a business and the well-being of its shareholders. Edward F. Smith, executive director of KPMG’s Audit Committee Institute, is quoted as saying, “From the audit committee’s perspective, it is essential that there be a culture of honesty and accuracy in reporting the numbers, as well as openness and transparency... And this culture starts with senior management and must extend throughout the organization.” (Our emphasis)

I couldn’t have said it better. It’s that very tone of honesty and transparency that Audit Integrity’s AGR® rankings were designed to reflect, and yet we see corporate executives continuing to set a deceptive – if not outright fraudulent – “tone at the top.”

The nature of the tone becomes particularly apparent in times of stress, and the current mortgage meltdown has provided some clear examples. For purposes of illustration, I selected one company out of many² that are showing themselves to be substantially out of tune.

Building Materials Holding Corporation (BLG), rated **Very Aggressive (AGR 36)** by Audit Integrity, is a very troubled company. In the six months ending June 30, 2007, Sales were down 30%, to \$1.3 billion versus \$1.8 billion for the same period in 2006. For the second quarter, the decline was 25% versus the same quarter a year ago. Robert E. Mellor, Chairman, President and CEO, stated “Market conditions remained very challenging during the second quarter, with year-over-year comparisons continuing to reflect the sharp correction occurring in the homebuilding sector. We were pleased that our focus on cost controls resulted in improved operating margins during the quarter and enabled us to return to profitability while generating positive cash flow.”

One cannot expect the CEO of a company to emphasize the bad news, but Mr. Mellor’s statement appears to be a deliberate diversion. While margins did improve for the quarter, this improvement pales in comparison to other issues the company faces, to which Mr. Mellor hopes his readers will turn a blind eye.

First, Accounts Receivable grew from \$280 million to \$329 million from December of 2006 through June, 2007 – an 18% increase – while Sales fell year-over-year. Accounts Receivable now stand at 48% of current period revenues, up from 44% on June 30, 2006.

¹ “Audit Committees Play Vital Role in Assessing Tone at the Top”, by Gary Larkin, August 2007.

² Of over 9,000 companies ranked by Audit Integrity, approximately 860 are rated *Very Aggressive*.

Even with this growth in Receivables, and concerns regarding the financial viability of the residential builders, both big and small, who comprise BLG’s primary market, allowances for Bad Debt were increased only 16%, from \$4.4 million in December 2006 to \$5.1 million currently. Doubtful accounts as a percent of sales was essentially unchanged at 0.75%. Does Mr. Mellor believe that the quality of his company’s Receivables has actually improved, and that there is no need to increase the provision for doubtful accounts in this environment, or is he being less than candid with his shareholders?

Mr. Mellor has also elected to fold into “Operating Income” a one-time gain of \$8.2 million (pre-tax) from the sale of real estate without a line item breakout for an item that increased net income before taxes from \$20 million to \$28 million. Does the company plan to liquidate assets on a continuing basis? If not, why include a one-time gain in Operating Income? What about the substantial increase in Long-Term Debt? Is it needed in order to carry Receivables, or for future acquisitions? Inventories have increased as Sales have fallen. Is the company buying low with the expectation of higher prices, or are they stuck with high-cost, swollen inventory?

This is not a good tone coming from the top.

The KPMG’s Audit Committee Institute piece goes on to quote Michael R. Young, in his book, **Accounting Irregularities and Financial Fraud**, as saying tone at the top “involves an unrelenting insistence upon accuracy in financial reporting. It involves an unrelenting insistence that numbers are not to be massaged. It is a tone that makes financial misreporting unthinkable.” In this case, Mr. Mellor is setting up his shareholders for a major disappointment unless the construction market turns upward quickly – an expectation that is not widely shared by his own customers.

Audit Integrity uses current accounting and governance practice as well as historical data in our forensic analysis of corporate integrity. Sadly, despite high-profile prosecutions and convictions in recent years, we have not seen a shift towards the tone so eloquently advocated in Mr. Young’s book. The number of companies whose senior management sets a tone of obfuscation in their disclosures to investors has remained constant. Our mission is to shine a light on the tracks they have attempted to cover, as well as to turn the spotlight on those companies who have proven trustworthy over time.

James A. Kaplan
CHAIRMAN

* This report includes corrections to data errors found after its original release date. Audit Integrity regrets these errors.