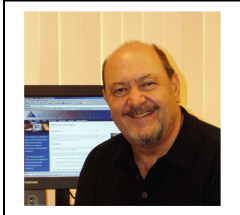


CHAIRMAN'S CORNER

by James A. Kaplan



Fraud: The Gauge of Innocence

May 27, 2009

I sense a change in the direction of the tides that bodes well, even during these tough times.

During the late 1990's, with prosperity rising year after year, it seemed the sky was the limit. The investment industry saw no reason not to remove the regulatory restrictions that had been put in place to safeguard investors after the Great Depression, which, surely, was not going to come again. As share prices went through the roof, shareholders saw no need to question the performance of Company managers, and did not examine the accounting practices that created an appearance of strength. Boards signed off on compensation structures that rewarded management for increasing share prices regardless of fraudulent, or at least, fraud-like behavior.

And from 2002 to 2007 (the Sarbanes-Oxley years), when the shaky underpinnings of these massive corporate megaliths began to give way, stakeholders learned a hard lesson – but the perfect storm of deregulation and deceptive accounting practice only grew in intensity.

In 2008 the real awakening began, and clearly, the emperor has no clothes.

The dramatic deterioration in economic conditions was the shot heard round the world. Economies are suffering in every nation. Foreclosures continue at an astronomical rate. Retirement funds have been decimated through no fault of the people who trusted professional money managers to invest wisely on their behalf.

The chasm between White Hats (companies with strong governance and transparency) and Black Hats (weak governance and transparency) has grown ever wider. Although stakeholders may have learned their lesson the hard way, I believe they have learned it well. When times were good, it may not have occurred to them to carefully examine the behavior of their executives.

Now that the market has deflated, we are discovering that integrity is not optional, but must be demanded regardless of rising or falling share prices. We have learned that fraudulent practices result in egregious short-term gain for the managers, who bear no risk and show no long-term commitment to the company's health, while resulting in devastating losses to the investors. Of course, our government, hearing the painful screams of stakeholders, has begun beefing up the very same regulatory bodies they de-regulated over the last decade.

I believe this changing tide will reinforce and strengthen the use of Audit Integrity's Accounting & Governance ratings, which quantify the distinctions between White Hats and Black Hats. Over the ten-year period ending December, 2008, annual stock return spreads averaged 15.29 percentage points difference between companies with the best and worst AGR[®] Equity Factor. During that time the worst decile returned -4.84% annually, while the best decile returned +10.54% annually.

In order to highlight these widening spreads, and to acknowledge those companies with strong governance and accounting, Audit Integrity will begin issuing regular reports on the “Most Trustworthy” companies which Forbes has published annually for the past three years. Our analysis indicates that these companies will continue to generate excess returns and avoid pitfalls over what I forecast to be economically turbulent years ahead.

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