GLASS
LEWIS & Co.

September 14, 2005

Mr. Jonathan G. Katz
Committee Management Officer
Securities and Exchange Commission
100 F Street NE
Washington, DC 20549-9303

Re: File Number 265-23

Dear Mr. Katz:

Glass, Lewis & Co., LLC is pleased to respond to the SEC Advisory Committee on Smaller Public Companies Request for Public Input (Release No. 33-8599; August 2, 2005). Glass Lewis is a leading independent investment research and proxy advisory firm, serving institutions that collectively manage more than $8 trillion in assets. Glass Lewis helps institutional investors make better informed investment and proxy voting decisions by identifying business, legal, governance and financial statement risks at more than 7,000 companies worldwide. The research staff at Glass Lewis has significant experience as financial executives at both large and small companies, and as auditors of both large and small companies.

The capital markets and investors need accurate financial data with which to make informed decisions as to where capital should be allocated and invested. Whenever the integrity and confidence in that data has been compromised, as was the case in recent years, the risk of loss by investors has increased significantly. As a result, it is important to the regulation of the securities markets, where money and profits no doubt drive human behavior, for sufficient investor protections to exist. These protections are necessary to minimize the types of events that occurred in 2000 to 2002, which to some degree continue to date.

We strongly believe the Sarbanes-Oxley Act of 2002 (SOX) creates improved governance, enhanced transparency, and higher quality financial reporting, which has increased investor confidence in the reliability of financial reports. This Act has, in our opinion, contributed to the investing public regaining confidence in the U.S. capital markets subsequent to when the market bubble burst contributing to trillion dollar losses in capitalization. This level of transparency also provides investors with higher quality and more timely information, which enables them to make better informed decisions as to where they should allocate their capital. We have heard from a number of business executives, including small businesses, as well as their professional advisors and stockholders that this information contributes to an improved relationship with their stockholders particularly long-term institutional investors.

We believe accurate and reliable financial reporting is necessary for investors to have confidence in the capital markets and the companies they choose to invest in. In turn, effective internal controls, as mandated by Congress in the 1977 Foreign Corrupt Practices Act (FCPA), are necessary to have accurate and reliable financial reporting, regardless of the size of the company. We note that Congress appropriately chose not to provide an exemption to smaller companies when they passed the FCPA and in 2002, Congress again chose not to exempt smaller companies from the provisions of SOX Section 404.

Effective information systems and internal controls benefit business, as well as investors. It is necessary for management to get complete, reliable and timely information if they are to make sound business decisions and successfully manage the company. We believe a successful business, which creates above average market returns for investors, goes hand in hand with effective internal controls and complete, timely and accurate financial reporting.

Our responses to the detailed questions the Advisory Committee has posed are attached to this letter. Some of the key points include:

1. It is vital that all public companies, large and small, provide accurate, timely and transparent financial information to investors. Rules that would permit a class of these companies to provide lower levels of transparency or accuracy for similar transactions are not in the best interest of the U.S. capital markets or the 90 million Americans who have invested therein. In addition, we believe such rules create a "second class citizen" with an implication of higher risk necessitating a need for a higher cost of capital. Were the Securities and Exchange Commission (SEC) to adopt such rules, it would be an undertaking to reduce the level of investor protection that exists today, only a few years after investors suffered hundreds of billions of dollars in losses.

2. The benefits of SOX outweigh the costs, especially when one considers the costs investors, the capital markets, and the economy suffered during recent years. We believe SOX has and will increase the attractiveness of the U.S. capital markets for well managed companies who are capable of generating shareholder value for their stockholders.

3. When investor confidence in the capital markets waned in 2000 to 2003, investors were reluctant or even unwilling to invest in companies going public. With the restoration of investor confidence, there has been a significant increase in both the number of initial public offerings and merger and acquisition activity.

4. When we consider the impact of the costs of implementing SOX such as audit fees, we believe there has not been a disproportionate burden placed on smaller companies.

5. We believe companies with internal controls in place, as required by the FCPA, will not incur unreasonably large recurring costs in complying with SOX 404. For these companies we also believe SOX will not increase the exposure to litigation. Indeed, SOX does provide a roadmap for improved financial reporting and governance that, when fully implemented, should aid in the quality of financial reporting and reduced incidences that may contribute to litigation. And while investor losses have grown to unprecedented levels in recent years, the percentage of those losses investors have recovered has declined.

6. We believe the independent external auditors should perform the testing of internal controls if they are the ones that are to report on these controls to investors. We believe it is very clear in SOX the testing is required to be performed on an annual basis. We would find it disconcerting if the SEC were to consider a rollback in this requirement, inconsistent with the law. A rollback will unquestionably reduce investor protection. We do not believe any such effort meets a cost versus benefit test unless the costs and benefits to investors are disregarded.

7. Internal controls do vary, in some cases significantly, from company to company. For example, the controls at large international companies will vary significantly from those at small companies. We believe the testing of internal controls should be tailored appropriately and be adjusted to reflect these differences. We also believe the existing rules and guidance of the Public Company Accounting Oversight Board (PCAOB) provide this degree of latitude and flexibility and as a result, further modifications to the rules are not necessary at this time.

8. Almost five years will have passed by the time non-accelerated filers and their auditors report on internal controls pursuant to SOX Section 404 and the currently established deadlines. We believe five years is long enough for any competent management team to test internal controls that have been required for almost three decades and to have those controls audited. Any further delay will

no doubt be an attempt to circumvent, rather than implement in a timely manner the law adopted by Congress.

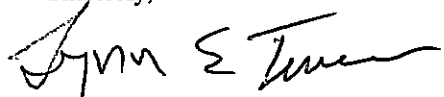
9. To allow investors to compare companies on an "apple to apple" basis, in a consistent manner, we believe all companies should account for similar transactions using the same financial reporting. The notion of "Big GAAP, Little GAAP" has been debated by accountants for decades. In the past it has always been rejected as it results in less transparency, lower quality financial reporting, and significantly lower levels of protections for investors. It is a notion that yet, once again, should be rejected for these same reasons.

10. We believe the current size tests used to determine what constitute a "small business" for purposes of Regulation SB are appropriate. We would not increase or otherwise modify them. However, as we note in our responses, we do not believe companies affording themselves the benefit of Regulation S-B should be provided an exemption from SOX. Rather, we believe a strong dose of common sense is needed in implementing the law.

We do believe it would be useful for the SEC to provide investors and market participants with useful information regarding small businesses listed on the U.S. capital markets. We note such information is virtually nonexistent in the SEC annual report.

We would be pleased to respond to any questions the SEC Staff or Advisory Committee might have after reviewing our responses to the questions posed.

Sincerely,



Lynn E. Turner
Managing Director of Research
Glass, Lewis & Co., LLC

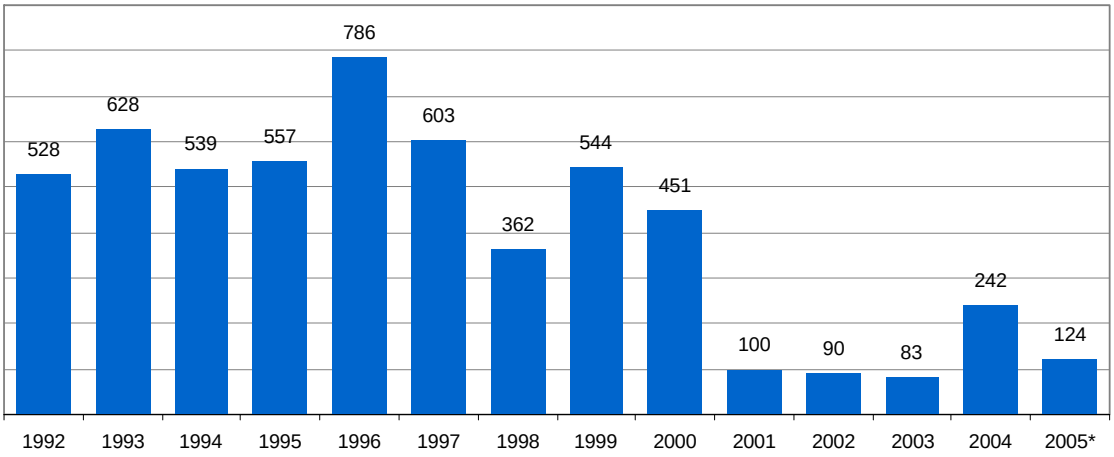
Attachments:
1) Responses to Detailed Questions Posed by the Advisory Committee
2) Appendix A – Market Capitalization Losses of "Smaller" Companies
3) Appendix B – Internal Control Questionnaire
4) Glass Lewis and Company Trend Alert: Control Deficiencies – Finding Financial Impurities
5) Glass Lewis and Company Trend Alert: Restatements – Traversing Shaky Ground
6) Glass Lewis and Company Trend Alert: Auditor Turnover Gains Momentum in 2004

Responses to Detailed Questions Posed by the Advisory Committee

1. Has SOX changed the thinking of smaller companies about becoming or remaining a public company? If so, how?

In 2004, the first year of the Sarbanes-Oxley Act of 2002 (SOX) Section 404 reporting requirements for accelerated filers, 242 companies conducted initial public offerings (IPOs) including 150 on the Nasdaq. In 2005, IPOs are on a pace to exceed 2004 levels with 86 completed through June 30, 2005.[1] As of Friday, August 19, 2005, 124 companies had come to the U.S. capital markets, one more than in the comparable period last year. Proceeds of $24.5 billion were raised, comparable to the $25 billion raised in the same period last year.[2] These IPO numbers compare to 100, 90, and 83 IPOs having been completed in 2001, 2002, and 2003, respectively, during a period when investors lost confidence in the integrity of the U.S. capital markets.[3] Obviously, those companies choosing to go public, and to take money from the public, have weighed the costs of additional investor safeguards and imposed regulations against the benefits of being a public company and have decided the benefits outweigh the costs.

Chart 1: Total Number of IPOs



Source: Nasdaq, IPO Monitor. * Through August 19, 2005.

The following excerpt from Roger Lowenstein's *Origins of the Crash* describes the scene of the U.S. capital markets in the fall of 2002:

> By September 2002 sixty telecom companies had failed, underwriting of new stocks had ceased, investment by American business had plunged, and consumer confidence was tumbling toward ten-year lows. By October 2002, the S&P had closed at 776—exactly half of the peak it had reached in March 2000. The Dow, barely above 7,000, had fallen 40 percent. This was the steepest decline in 30 years. The Nasdaq had closed in on 1,100, a fall of 78 percent, the largest slide by a major index since the Great Depression. Of some 825 companies that had gone public in 1999 and 2000, 715 were below the offer price and 303 were trading under $1 or had been delisted. During the Great Crash of 1929, despite little change in the economy, in October and November of '29—stocks fell by half. Coincidentally, in 2000-02, the S&P 500 fell by exactly the same amount; the Dow, a little less; the Nasdaq, with all its small companies, considerably more.[4]

There can be no question that the downturn in the level of IPO's occurred well before SOX was ever adopted, as a result of a downturn in the economy leading to the recession at the end of 2001 and the loss of investor confidence

[1] Source: IPO Monitor.
[2] New York's debutantes prove to be the belles of the ball. Financial Times, August 24, 2005.
[3] Source: Nasdaq.
[4] Origins of the Crash, Roger Lowenstein, Penguin Press, 2004, p. 208-220.

in the market place. Accordingly, since the passage of SOX, the number of IPOs, as well as the amount of capital raised, has once again begun to rise as noted in the chart above. Glass Lewis believes SOX has enhanced the ability of companies to once again attract capital from the public and to do so with greater transparency and market discipline. The SOX 404 regulatory environment provides greater protection to the investing public, which Glass Lewis believes should be the highest priority of the Securities and Exchange Commission (SEC or Commission).

A study of companies going private has noted the number of going private transactions in 2004 totaled 114, well below the number of companies choosing to go public.[5] Of course, the decision for a company to go private or undergo a leveraged buyout may be influenced by a number of factors. For example, the recent announcement that Albertson's Board of Directors is exploring strategic alternatives to increase shareholder value, including a possible sale of the Company, is likely influenced by the competitive pressures of Wal-Mart and other competitors.

2. Has SOX affected the relationship of smaller companies with their shareholders? If so, how?

SOX creates improved governance, enhanced transparency, and higher quality financial reporting, which has increased investor confidence in the reliability of financial reports. This level of transparency also provides investors with higher quality, more timely information that enables them to make better informed decisions as to where they should allocate their capital when investing. We have heard from a number of executives in business, including small businesses, as well as their professional advisors and stockholders that this information contributes to an improved relationship with their stockholders, particularly long-term institutional investors.

We believe SOX, when fully implemented, will contribute to a reduction in the number of small companies reporting restatements and material weaknesses in internal controls. Such "surprises" negatively impact relationships with stockholders. As noted in the attached reports, 548 companies of under $100 million in market capitalization have reported restated financial statements in 2003 and 2004, representing 48% of total restatements.[6] Huron Consulting, in their report, *2004 Annual Review of Financial Reporting Matters*, states "on average, over the past five years, *nearly 75 percent* of all financial restatements were reported by companies with annual revenues of less than $500 million [emphasis supplied]."[7] In addition, although SOX 404 requirements are not yet effective for small companies, 600 small companies (less than $100 million market capitalization) have reported material weaknesses in the 18 month period ending June 30, 2005.[8]

3. Do you believe SOX has enhanced, or diminished, the value of smaller companies? Please explain.

Ultimately, we believe it is the success of a business that generates its value or lack thereof, not government regulations. However, our experience has shown factors such as good governance, timely management decisions facilitated by excellent information systems and good internal controls, and effective risk management all contribute to a company being able to improve its cash flows, and accordingly, its long-term value. To the extent SOX brings about improvements in governance, internal controls and management information systems, more qualified audit opinions, and greater transparency which results in greater capital market discipline, we believe SOX will help enhance the value of companies of all sizes.

Conversely, if some companies are granted exemptions from the requirements of SOX, there will be a higher risk for investors that such companies lack adequate internal controls and management information systems, independence in their governance process, and less transparency in their financial reports, preventing market discipline from operating effectively. This in turn will create a "second class" corporate citizen that will, and should, have to pay a higher risk premium to attract capital from the public. Just as with lenders, when the risks of providing capital are increased, the cost of that capital also increases.

A survey of executives by Oversight Systems states "nearly three quarters (74 percent) say their companies realized a benefit from SOX compliance." The report went on to state the 37 percent of those surveyed said SOX increased shareholder value while 33 percent believed the costs of SOX had a negative impact on their stock valuations.

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[5] The Costs of Being Public After Sarbanes-Oxley; The Irony of 'Going Private', William J. Carney, Working paper No. 05-4.

[6] Glass Lewis and Company Trend Alert: Restatements – Traversing Shaky Ground, May 2005.

[7] 2004 Annual Review of Financial Reporting Matters, Huron Consulting Group.

[8] Glass Lewis and Company Trend Alert: Control Deficiencies – Finding Financial Impurities, June 2005.

Overall, "despite the high costs of compliance, most financial executives (57 percent) describe their company's Sarbanes-Oxley compliance as a good investment for stockholders, and 79 percent say they have stronger internal controls after complying with the Enron-inspired law, according to the 2004 Oversight Systems Financial Executive Report on Sarbanes-Oxley Compliance."[9] Similarly a 2005 Oversight Systems survey found that "most financial executives say that after implementing SOX requirements to remediate control deficiencies, most companies have seen bottom-line business benefits. Nearly half, 49 percent, say SOX compliance resulted in reduced risk of fraud and errors; 48 percent say they now have more efficient financial operations; and 31 percent say error rates have declined."[10]

4. Has the current securities regulatory system, including SOX, increased or decreased the attractiveness of U.S. capital markets relative to their foreign counterparts for companies? For investors? Please explain.

We note the number of companies listed on the NYSE and Nasdaq declined from 2,862 and 4,832 respectively in 2000 to 2,768 and 3,293 in 2004.[11] This is a decrease of 3.3 percent and 31.8 percent respectively. We also note during the period from December 31, 2000 to December 31, 2004 the number of foreign companies registered and reporting with the U.S. Securities and Exchange Commission declined from 1,310 to 1,240, a decline of 5.3 percent. However, foreign registrants increased from 417 to 439 on the NYSE during this time period.[12] These statistics indicate that the change in the level of foreign listings is not significantly different than for U.S. companies, and perhaps indicates a greater interest in foreign companies than U.S companies.

The New York Stock Exchange and Nasdaq market capitalizations have increased from $11.6 trillion at the end of 2002 to $17.4 trillion as of June 30, 2005.[13] In addition, as noted in our response to question No. 1, there has been a significant increase in the number of initial public offerings. This information would indicate investor confidence in the capital markets has increased since the disclosure of many corporate frauds in recent years. We believe that confidence is the result, in part, of the provisions of SOX.

In addition, we note the Nasdaq Chairman has said the Sarbanes-Oxley Act was not harming the second-largest stock market by capitalization in the U.S. "Good regulation is good business," Bob Greifeld remarked in an interview with the Financial Times. Mr. Greifeld added the cost of not having the verification procedures mandated by the Act far exceeded the expense of implementing such procedures. He also noted, "international companies accounted for about 10 percent of Nasdaq's listings. He hoped that number would reach 15 percent within three years and said the exchange had recruited additional staff to reach that goal."[14]

5. Does the current securities regulatory system adversely impact or enhance this country's culture of entrepreneurship? Has the current system impaired or enhanced the ability of American companies to compete on a global basis? If so, how?

Glass Lewis is very supportive of entrepreneurship, having been founded as a start-up company just over two years ago. As such, we are supportive of efforts to increase the level of successful entrepreneurial companies in the U.S. However, at the same time, we do not believe entrepreneurship has anything to do with executives taking money from the public in anything less than a highly transparent fashion. Also, we do not believe entrepreneurship involves taking money from the public when a company lacks adequate controls to ensure accurate financial statements and stewardship of the investing public's assets. We believe some have used terms such as "entrepreneurship" to hide systematic failures and poor, or even corrupt, corporate management, which have resulted in misstated financial statements, a lack of internal controls and investor losses.

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[9] The 2004 Oversight Systems Financial Executive Report on Sarbanes-Oxley, Oversight Systems, 2004. 222 corporate financial leaders from across the U.S. participated in the study including those who were a CFO, controller, treasurer, vice president or director. Of the sample, 45 percent were with companies with over $ 1 billion, 22 percent were in companies with revenues of between $251 million and $999 million and 30 percent had revenues of less than $250 million.

[10] The 2005 Oversight Systems Financial Executive Report on Sarbanes-Oxley, Oversight Systems, 2005.

[11] Source: NYSE and Nasdaq.

[12] Reports of the U.S. SEC, Foreign Companies Registered and Reporting with the U.S. Securities and Exchange Commission, December 31, 2000 and December 31, 2004. Office of International Corporate Finance, Division of Corporate Finance.

[13] Source: NYSE and Nasdaq.

[14] Sarbanes-Oxley Act 'not harming Nasdaq' – EXCHANGES. Financial Times, June 1, 2004, Page 24.

We believe the current securities regulatory system in the U.S. enhances this country's business culture of entrepreneurship by providing entrepreneurs access to available capital. Perhaps the best evidence is no other capital market system comes even remotely close to providing the level of available equity capital provided by the U.S. capital markets to businesses of all sizes. Investors are willing to put their dollars to work in the U.S. capital markets because they are provided with reasonable protections and sufficient levels of transparency which allow them to make informed investment and risk decisions, thereby increasing their returns.

In addition, we note last year, subsequent to the passage of SOX, the earnings of 449 companies in the S&P 500 which filed an annual report in compliance with SOX 404 grew 18.2%. At the same time, another 2,618 companies in the Russell 3000 with fiscal year ends occurring in the period of SOX 404 compliance saw their earnings levels grow by 15.3%.[15]

Some business executives have complained about the impact on their bottom line as a result of the costs related to implementing SOX. However, the costs of SOX compliance may well pale in comparison to those of executive compensation. While the profits benefiting investors grew the past year, so did compensation for executives at companies in the S&P 500 and Russell 3000 complying with SOX 404, which increased 67% from 2003 to 2004.[16] Considering U.S. executives are paid more than 300 times what a factory worker is paid,[17] compared to a ratio of 30 in Europe, we find it more than just interesting executives complain about a cost related to investor protections while few speak out about the explosion in executive compensation.

Rules calling for effective internal controls are not new. Since 1977, with the enactment of the Foreign Corrupt Practices Act (FCPA), companies have been required to have effective controls. SOX Section 404 does require an independent auditor to attest to these controls. Similarly, for over a decade, the Financial Executives International (FEI) has called upon its members, both big and small, to report on their internal controls to shareholders. Unfortunately few have heeded this voluntary best practice.

6. Has SOX resulted in a diversion of the attention of company management away from operational activities, or otherwise imposed an opportunity cost on the management of smaller public companies? If so, have the benefits of SOX justified the diversion or opportunity cost? Please explain.

We do not believe management of companies who had previously complied with the 1977 FCPA will be required to divert significant resources away from other activities on an ongoing basis. This is especially true for the initial implementation of SOX Section 404. However, for those companies who have not complied with the law, placing their stockholders at greater risk of financial statement errors and the potential market impacts, additional time would be required to remedy the deficiencies identified.

Companies have now had more than three years since the passage of SOX in July 2002 to implement Section 404. The extension granted in March 2005 by the SEC gives calendar year-end, non-accelerated filers[18] nearly five years to get their internal controls working effectively and audited. A management team that cannot complete this task within this timeframe is simply incompetent. We note many companies have already completed this task. We are strongly opposed to the SEC granting another extension which would push the compliance deadline for small companies back to July 2007, five years after the passage of SOX. We believe this would be a direct attempt to avoid the 2002 mandate passed by Congress.

We note executives of small companies had previously certified to the SEC and stockholders their internal controls were adequate, but then surprised them when they later disclosed material weaknesses existed. Given that stockholders were certainly not provided such information when the company went public, it is an appropriate remedy to require management to spend the resources necessary to provide investors with adequate protection going forward.

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[15] Source: Glass Lewis, FactSet.
[16] Source: Glass Lewis.
[17] Special Report – Executive Pay, Business Week, April 19, 2004.
[18] Non-accelerated filers are generally companies under $75 million in market capitalization.

The SOX regulatory environment has created a positive discipline to improve the quality, transparency and integrity in financial reporting which has dramatically improved companies' systems of internal control and enhanced management's ability to manage the company. The opportunity cost is not the result of the SOX regulatory environment, but rather the cost to companies and investors to fix errors resulting in financial statement restatements. CEOs and CFOs have signed statements for three years certifying their financial statements. These certifications in too many cases have provided inadequate information to investors. As we noted earlier, almost half (48%) of the companies restating their financial statements in 2003 and 2004 were small companies with market capitalizations of less than $100 million. The number of restatements for 2005 is continuing to rise at record levels to close to 1,100 through August, already surpassing the number of restatements for all of 2004. Getting the financial statements right the first time would dramatically decrease opportunity costs and improve investor confidence in the reliability of financial statements.

7. Does the current securities law disclosure system properly balance the interests of investors in having access to complete and accurate information for making investment decisions with the need for companies to protect information for competitive reasons? Please explain.

Yes. For all too long we have seen companies use "competitive reasons" as an excuse to avoid transparency. For example, companies have used this argument to try to circumvent or avoid segment disclosures. Yet we have not seen where these aggregated disclosures have negatively impacted the competition of U.S. public companies.

American investors are not asking for the "secret formula" for the "special sauce." Rather they have requested information necessary to evaluate management accountability with respect to past financial performance, as well as to understand current trends so as to make informed decisions with respect to the future success of the business. In that respect some financial reporting today is frequently too summarized to be meaningful. In addition, information such as Key Performance Indicators, which are very relevant to assessing the future profitability of a business, is currently not available but should be. We commend the SEC for urging registrants to make greater disclosure of such information in their financial reports. Unfortunately, not enough companies today are heeding the SEC's recommendation.

It is also important to note that vendors and customers also prefer doing business with transparent, well controlled companies. No one likes negative surprises.

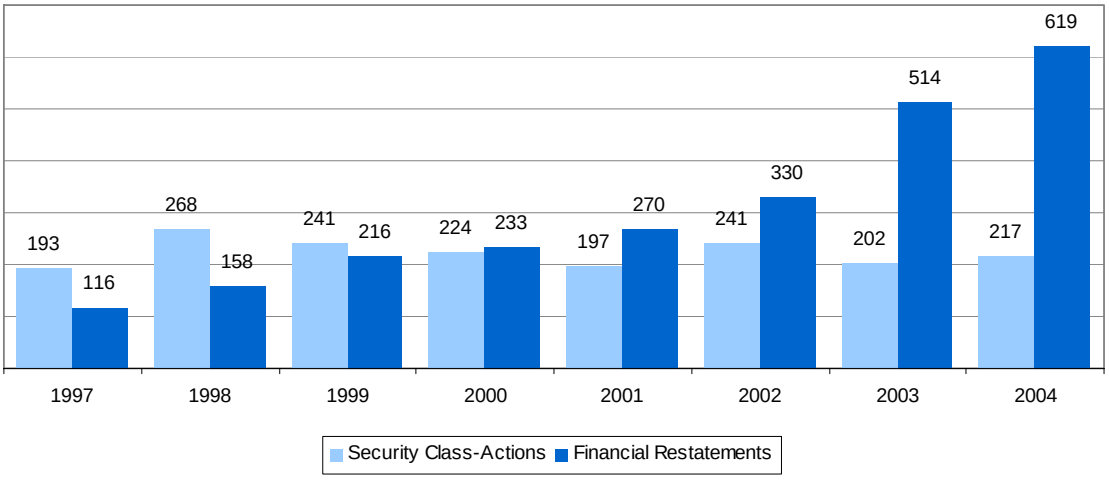
8. Has the current securities regulatory system had an impact on the amount and type of litigation to which smaller companies are subject? Has the overall impact on companies, investors and markets taken as a whole been positive or negative? Please explain.

We believe the current securities regulatory system, including the numerous "safe harbor" protections it affords those who act in a responsible fashion, does have a positive impact on litigation to which smaller companies are subject. Unfortunately, the number of companies with under $100 million in market capitalization that restated their financial statements rose from 266 in 2003 to 282 in 2004, a 6% increase. In addition, 600 companies of this size also reported material weaknesses in internal controls in 2004 and through June 30, 2005. We note many of these recently uncovered problems originated before SOX was passed.

As a result of the increase in companies failing to comply with the laws passed by Congress to protect investors, it should be expected there will be increased litigation as investors attempt to recoup losses they have suffered in the market place and deter others from engaging in similar unlawful conduct in the future. However, we note overall the number of securities class-action lawsuits have remained relatively flat compared to the number of financial restatements (Chart 2). And while investor losses suffered in the marketplace have increased exponentially in the past few years, the percentages of such losses recouped have declined from 4% in 2000 to 2.3% in 2004.[19]

[19] Recent Trends in Shareholder Class Action Litigation, NERA Economic Consulting, February 2005.

Chart 2: Number of Security Class-Actions Compared to Financial Restatements

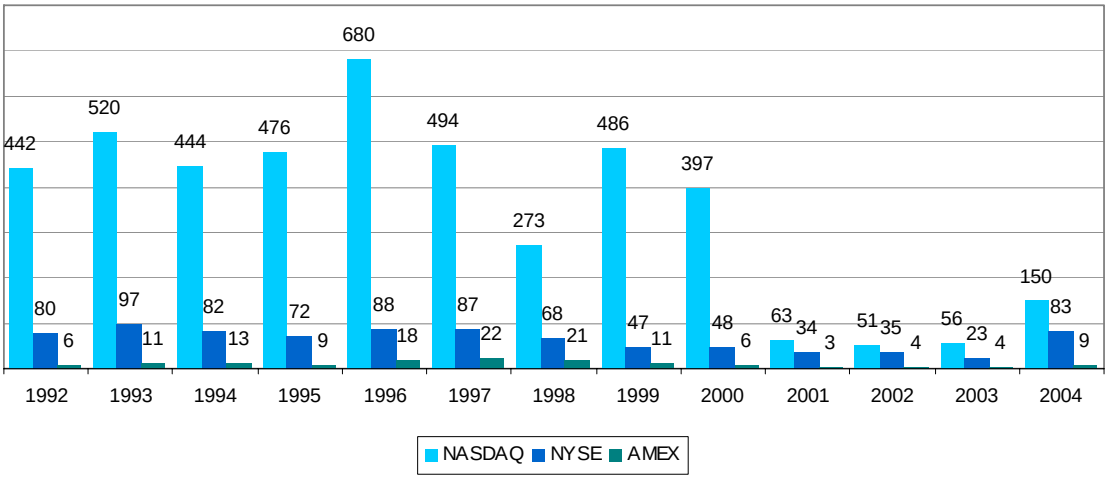


Source: Glass Lewis, NERA Economic Consulting.

9. Has SOX changed the capital raising plans of smaller companies? If yes, how have those plans changed?

Two hundred forty-two companies conducted initial public offerings in 2004 and a greater number are projected to do so in 2005 while complying with the SOX regulatory environment. Chart 3 below shows the number of IPOs on the major exchanges for the last ten years. Since the passage of SOX, the number of IPOs has increased three- and four-fold on the Nasdaq and NYSE in 2004 from their levels in 2002 and 2003.

Chart 3: Number of IPOs by Market



Source: Nasdaq.

The current regulatory environment creates a necessary discipline for smaller companies, which enhances their system of internal control and improves the accuracy and timeliness of their financial information which over time can only reduce their cost of capital. Glass Lewis believes that SOX has only enhanced the capital raising plans of smaller companies.

Has SOX affected the thinking of smaller companies about buying or being acquired by other companies or looking for merger partners or acquisition targets? Explain your answer and indicate any way in which SOX has changed a smaller company from a buyer to a seller of a business, or vice versa.

The statistics set forth below, from various sources, clearly indicate merger and acquisition activity has once again risen, after experiencing a significant drop when the "bubble" in the stock market burst, contributing to an economic recession and a significant drop in investor confidence. Both the number and transaction value have risen and the multiples paid have done so as well.

Table 1: Merger and Acquisition Activity (U.S.)

	Transaction Volume	Transaction Value *($ billions)*
2005*	4,710	$518.0
2004	9,964	$777.0
2003	7,894	$528.0
2002	7,874	$461.0
2001	8,224	$702.8
2000	9,472	$1,330.0
1999	9,278	$1,450.0
1998	7,809	$1,192.0
1997	7,700	$650.7

Source: FactSet Mergerstat. * 2005 includes deals through June 30.

An article in the National Law Journal (February 7, 2005) states that "several outside attorneys say that SOX, as it is often called, has paved the way for deals because it has inspired greater confidence in the accounting of publicly traded companies. It's pumped up the diligence in due diligence, they say, and prodded everyone—including lawyers—to sit straight." The article notes that "the number of deals jumped from 7,699 in 2003 to 8,377 last year—an increase of 9%, according to Thomson Financial. But the dramatic increase was in their value. Deals in 2003 totaled $567 billion, compared to $834 billion in 2004, a leap of 47%. The only sectors that gave ground were industrials and consumer staples." As Phillip Ricter, a partner at Fried, Frank, Harris, Shriver and Jacobsen said, on balance, "Sarbanes Oxley has had a positive impact on transactions." He noted as more confidence in publicly available information has been generated, more companies are considering deals.[20]

Table 2: Merger and Acquisition Activity by Region

	United States		Global	
	Transaction Volume	Transaction Value *($billions)*	Transaction Volume	Transaction Value *($billions)*
2005 1H	4,222	$592.0	5,246	$1,300.0
2004 1H	4,335	$423.0	5,520	$885.0

Source: Thomson Financial.

Table 3: Merger and Acquisition Activity in the Smaller Market

	Total		Deal Size					
			$50 to $99M		$25 to $49M		$1 to $24M	
	Volume	Value *($billions)*	Volume	Value *($billions)*	Volume	Value *($billions)*	Volume	Value *($billions)*
2005 2Q	2,414	$275.0	90	$6.3	124	$4.3	392	$3.3
2005 1Q	1,986	$243.0	74	$5.1	93	$3.3	313	$2.8
2005 1H	4,400	$518.0	164	$11.4	217	$7.6	705	$6.1

Source: FactSet Mergerstat. Note: Total Volume difference of 310 for 1H of 2005 shown in Table 1 not reconciled by FactSet Mergerstat.

SOX Section 404/Internal Controls

10. In developing a "risk-based" approach for assessing and auditing internal control over financial reporting for smaller companies under SOX Section 404, what criteria would you use to categorize internal controls from the highest risk to the lowest risk controls?

Small businesses tend to have fewer personnel on their accounting and finance staff. As a result, the lack of segregation of duties and greater reliance on corporate governance, senior executives and monitoring controls,

[20] M&A liftoff in the new era of SOX: Some lawyers assert that Sarbanes-Oxley helped boost the rise in deals last year, National Law Journal, February 7, 2005, p. S1. Note: Difference in number of deals reported in article and tables due to different sources.

provide control risk issues. This is supported by findings in *Fraudulent Financial Reporting: 1987-1997 – An Analysis of U.S. Public Companies*.[21] This report noted "relative to public registrants, companies committing financial statement fraud were relatively small." It goes on to state, "when considered together, in 83 percent of the cases, the Accounting and Auditing Enforcement Releases (AAER) named either or both the CEO or CFO as being associated with the financial statement fraud." We believe lax corporate governance, including audit committees who don't get the job done right, facilitate the ability of executives to engage in such behavior.

As a result, we believe the criteria should emphasize:

(a) The lack of segregation of duties.

(b) The key roles executives play, including monitoring the financial reporting process and internal controls.

(c) A competent oversight and governance function, including an effective audit committee, which becomes especially important in light of (a) and (b) above.

(d) The need for competent personnel. The attached report on weaknesses in internal controls sights this as one of the more significant reasons underlying companies reporting material weaknesses in internal controls.

(e) A mechanism for employees to report inappropriate behavior to an independent party such as the audit committee.

(f) The ability to identify and manage change on a timely basis as the company grows.

We believe there are differences between internal controls in a large international business such as General Electric, Disney or Coca Cola and a small company such as one with $10 million in revenue. We believe those differences must be recognized when assessing an effective internal control system. We also believe the way controls are documented and tested should recognize the differences.

For example, a company with under $25 million in revenues, should be able to document its controls through the completion of an internal control questionnaire such as the one attached hereto in Appendix B. Such a questionnaire recognizes the differences in operations and controls that exist between a small company and their larger counterparts. We do believe such a questionnaire should adequately document key internal controls, and sections of it may be deleted or expanded depending on the nature of the business and its controls. However, by using such a control questionnaire, which considers differences in control structures as is highlighted in the questionnaire, documentation and testing could be simplified. We believe this questionnaire could be easily completed by the internal staff of a small company, and then provided along with any additional relevant data to the external auditors, without an overly burdensome level of costs. In turn, we then believe the auditors could test the applicable controls so as to provide a basis for a conclusion as to whether the relevant internal controls are operating effectively. We also believe such an approach to assessment and testing of internal controls pursuant to SOX 404 would provide investors with appropriate information for a smaller company, with simple basic systems, at a reasonable cost.

11. Do you believe that at least some SOX Section 404 internal controls for smaller companies can be appropriately assessed less often than every year? If so, what SOX Section 404 internal controls do you think need to be assessed by management ever year?

No. We do not believe internal controls can be assessed less than annually while having executives annually certify those controls are in fact effective and working as they should. When a company (big or small) takes money from the investing public it makes a representation to its new owners that it has reasonable internal controls operating effectively. To ensure that is the case, it is questionable at best, and more likely highly doubtful management can make that representation without testing those controls on an annual basis.

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[21] Fraudulent Financial Reporting: 1987-1997 An Analysis of U.S. Public Companies. Research Sponsored by the Committee of Sponsoring Organizations of the Treadway Commission, 1999.

Internal controls require periodic maintenance to ensure they are operating effectively. Likewise, they are not like a light switch that can be turned on and off on an annual basis. Furthermore, far too many executives have already reported and certified their internal controls were adequate, only to have their stockholders left wondering later when the independent auditors report material weaknesses. As noted in the attached report, 94% of companies receiving a qualified audit opinion on internal controls had their CEOs and CFOs, in accordance with Section 302, previously certify that internal controls were effective as recent as one quarter prior to their audit firm issuing the qualified opinion. Accordingly, internal control effectiveness can only be determined if key, significant controls are tested on an annual basis and not on the basis of cycle testing. Also noted in the control deficiencies report, 246 and 354 companies with market capitalization of less than $100 million have disclosed material weaknesses in 2004 and 2005, respectively.[22] This is despite the fact the required reporting and independent audit requirements under SOX have yet to go into effect, which leaves one wondering what will occur when they do!

What controls do you think need to be assessed at least every two years?

See our response above. We believe this is a leading question as we believe controls should be tested on an annual basis. In addition, we note that SOX Section 404 states:

> (a) RULES REQUIRED.—The Commission shall prescribe rules requiring *each annual report* required by section 13(a) or 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78m or 78o(d)) to contain an internal control report, which shall— (1) state the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting; and (2) contain an assessment, *as of the end of the most recent fiscal year* of the issuer, of the effectiveness of the internal control structure and procedures of the issuer for financial reporting [emphasis supplied].
>
> (b) INTERNAL CONTROL EVALUATION AND REPORTING.—With respect to the internal control assessment required by subsection (a), each registered public accounting firm that prepares or issues the audit report for the issuer shall attest to, and report on, the assessment made by the management of the issuer. An attestation made under this subsection shall be made in accordance with standards for attestation engagements issued or adopted by the Board. Any such attestation shall not be the subject of a separate engagement.[23]

Accordingly, we believe it would be contrary to the investor protections provided in the SOX legislation to permit less than annual testing.

What controls do you think could be assessed only once every three years?

See above response.

12. Current standards require that the auditor must perform enough of the testing himself or herself so that the auditor's own work provides the principal evidence for the auditor's opinion. Are there specific controls for smaller companies for which the auditor should appropriately be permitted to rely on management's testing and documentation? Are there specific controls for smaller companies where this is particularly not the case?

The current auditing standards of the Public Company Accounting Oversight Board (PCAOB) are appropriate as they relate to this question. The reporting on controls should be done by the party testing the controls.

It would be highly misleading to investors for auditors to report on the effectiveness of internal controls, signing their name, if, in fact, the testing was performed by non independent management. Already the credibility of the auditing firms has suffered as a result of numerous undetected misstated financial statements where they had given

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[22] Glass Lewis and Company Trend Alert: Control Deficiencies – Finding Financial Impurities, June 2005. The number of companies with market capitalization less than $100M reporting material weaknesses in 2005 is as of June 30. The 354 reported is comprised of 239 included in the attached report as of May 2 and an additional 115 from that point through June 30.

[23] PUBLIC LAW 107–204—JULY 30, 2002, SEC. 404. MANAGEMENT ASSESSMENT OF INTERNAL CONTROLS, http://www.sec.gov/about/laws/soa2002.pdf.

investors a "clean bill of health" for the company. Auditors issuing their own independent audit opinions in reliance on testing by management, who has a vested interest in the outcome of the results, would only further exacerbate the credibility issues auditors currently face.

We believe it is important to note 514, 619 and 1,100 companies in 2003, 2004 and 2005,[24] respectively, have filed financial statements with errors, which later had to be restated. We also believe in most instances, the need to restate financial statements is accompanied by a material weakness in internal controls.

13. Is the cost and timing of SOX Section 404 certification a deterrent to smaller companies going public? Are there companies where this deterrent is appropriate? (i.e., are there companies that should not go public and is SOX Section 404 one appropriate control on the process?) If there is such a deterrent, would it be appropriate to provide some exemption or special consideration to companies that have recently gone public, and for how long would you extend this special treatment?

We believe companies with ineffective controls, and the resulting risk of producing misleading financial statements, should not be permitted to take money from the investing public. Exemptions from this basic concept should not be considered. Our experience as business executives lead us to believe that companies who lack the requisite controls also tend to underperform their peers. Accordingly, we view the cost of SOX Section 404 certification to be a part of doing business in addition to part of the cost of accessing the capital markets.

It is also important to note lenders and providers of private equity capital in the private sector also take steps to adequately reduce their risks. For example, it is common that a provider of loans or equity to a private company will often require a "no material change" clause.

During the period from 2000 through 2002, the U.S. capital markets experienced a "once in a lifetime" event as the Nasdaq dropped from a high of 5048 to a low of 1114 and the New York Stock Exchange also experienced a severe drop in value. Market participants watched as trillions in dollars of market capitalization evaporated, largely due to a lack of confidence of investors in financial reports. And many well managed small and large businesses were impacted as their ability to access necessary capital was also curtailed, as the result of not just a few bad apples, but rather many in the orchard not having the types of controls in place necessary to avoid the epidemic loss in investor confidence.

While the management of some companies may decide the costs and resources necessary to ensure accurate reporting to shareholders are too high, and as a result, choose not to access the capital markets, we do not believe that is the reason to create a system that will lay the foundation for the next stock market bubble. If a company is unwilling to pay the price necessary for entrance into the public marketplace, it should not be permitted to list on an exchange. This should not be a race to the lowest common denominator as some would recommend. Rather the standard should be set to ensure the U.S. capital markets maintain the confidence of investors, who in turn are willing to provide capital to companies who can generate the greatest returns on that capital.

We note the current system of Small Business regulation already creates "second class" citizens. For example, many small companies cannot currently attract analyst coverage contributing to a lack of liquidity in their stock and are rejected by audit firms as too risky. In fact, "The vast majority of 14,000 publicly traded companies in the U.S. do not have analysts tracking their earnings and operations."[25] In turn, large institutional investors shun or outright prohibit their portfolio managers from investing in these companies. These are market-based decisions which should provide a lesson to be learned from, not a mistake to be repeated. The result is these companies face higher costs for the capital they are able to attract. Putting another negative label on these companies, highlighting additional risks because they might lack the basic controls necessary to prepare accurate financial statements, will only further the second class citizenship. As a result, we do not believe further exemptions contributing to higher risks for investors and second class citizenship for companies are advisable or warranted.

During 2000, two well respected business leaders met with the then SEC Chairman and Chief Accountant. During the meeting they expressed what turned out to be a valid concern. The concern was the dot.coms were attracting

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[24] Source: Glass Lewis. Number of restatements in 2005 is through August 31.

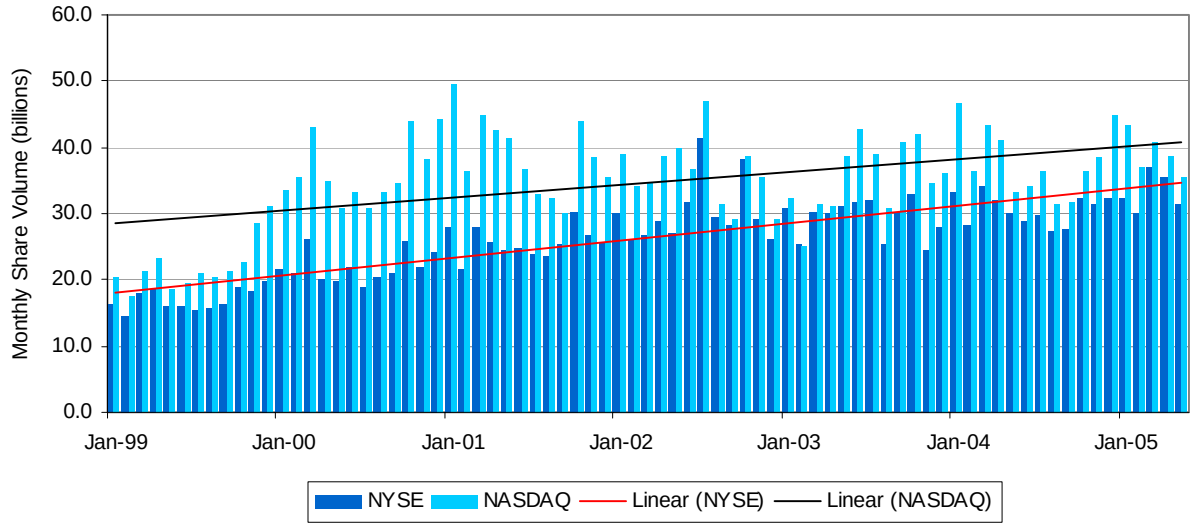
[25] America Robbed Blind – How Corporate Crooks Fleeced American Shareholders, Greg Farrell, Wizard Academy Press, 2005, p. 147.

capital away from successful businesses, either raising the cost of capital to those businesses or leaving them without capital. As a result, in part due to a lack of transparency, inefficient allocation of capital in the marketplace was occurring, which we believe ultimately contributed to a severe drop in the capitalizations of the market and an unwarranted increase in the cost of capital for some companies.

14. Do the benefits of SOX Section 404 outweigh its costs for smaller companies? Please explain.

Yes. The benefits of SOX have included a restoration of investors' confidence in the capital markets. This in turn has contributed to an increase not only in public offerings, but also an increase in the volume of market activity (Chart 4). As users of financial data, we also believe the ability of investors to make more informed investing decisions, leading to greater returns, has also been a benefit.

Chart 4: Monthly Share Volume of NYSE and Nasdaq



Source: NYSE, Nasdaq.

We believe these benefits also are enjoyed by small businesses that have participated in public offerings and improved their business with better internal controls. Many of these companies were denied access to the markets in 2001 through 2003 as opportunities for public offerings "dried up."

The operational benefits of SOX Section 404 outweigh its costs for smaller companies. The SOX Section 404 regulatory environment improves internal controls and increases the accuracy and timeliness of financial information. Management benefits include better data to manage the company and, consequently, create greater long-term shareholder value. In a 2004 survey of financial executives by Oversight Systems, 74 percent of the respondents (including 30 percent at companies with revenues of $250 million or less) say their company benefited from Sarbanes-Oxley compliance.[26] Three-fourths of the respondents also indicated that they would vote to keep Section 404 as is if they were members of Congress.

We note the aggregate audit fees for companies with revenue under $100 million increased $217.2 million (52%) from 2003 to 2004 (Table 4). This increase compares to $1.2 billion (56%) for the S&P 500 and $1.2 billion (85%) for the remainder of the Russell 3000.[27] Small Business filers, submitting annual reports on Form 10KSB, experienced an increase of $20.2 million (21%). Accordingly, it does not appear small businesses incurred a disproportionate cost when compared to medium or larger sized companies.

[26] The 2004 Oversight Systems Financial Executive Report on Sarbanes-Oxley, Oversight Systems, 2004.
[27] Source: Glass Lewis.

Table 4: Audit Fees of Companies with Revenue Under $100 million

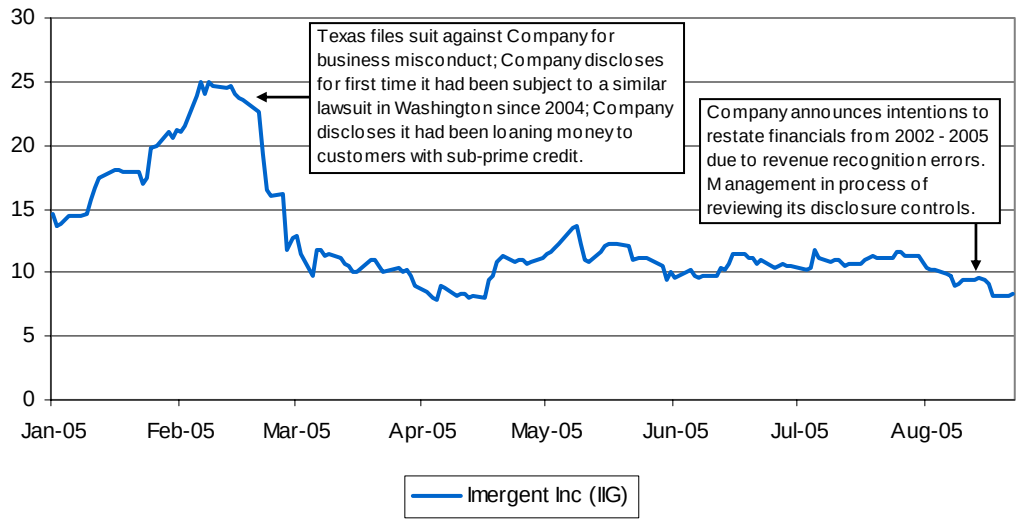
	Less than $100 M Revenue (Including some SBs)[1]				Small Business Filers (SBs Only)[2]			
Fees *($ millions)*	2004	2003	$ Change	% Change	2004	2003	$ Change	% Change
Audit	$637.7	$420.5	$217.2	51.7%	$115.3	$95.1	$20.2	21.2%
Audit Related	$72.1	$53.0	$19.1	36.2%	$11.2	$8.2	$2.9	35.4%
Tax Related	$82.8	$82.6	$0.2	0.2%	$10.9	$10.2	$0.7	6.9%
Other/Misc	$23.2	$24.2	-$1.0	-4.2%	$5.5	$4.7	$0.8	15.9%
Total Non Audit[3]	$178.0	$159.8	$18.2	11.4%	$27.5	$23.2	$4.4	18.9%
Total	$815.7	$580.3	$235.4	40.6%	$142.8	$118.3	$24.5	20.7%

Source: AuditAnalytics.com. We appreciate their assistance in providing this data.
Notes: (1) Includes 3,988 publicly traded SEC registrants with revenue less than $100M, including approximately 1,300 Small Business filers, who disclosed paying auditor fees for both fiscal year 2003 and 2004. (2) Includes 2,264 Small Business filers who disclosed paying auditor fees for both fiscal year 2003 and 2004. (3) Total Non Audit includes Audit Related, Tax Related, and Other/Misc.

We believe the costs of SOX 404 pale by comparison to (1) the losses suffered by investors, (2) the impact the downturn in the markets had on the economy and (3) the subsequent losses in jobs suffered by Americans as is further discussed in our response to question No. 13 and the attached report on internal control weaknesses. We believe Congress recognized the benefits of SOX to investors when they passed the Act in the summer of 2002.

We agree with Linda Scott, Director of Corporate Governance at TIAA-CREF, when she says, "We'd like to see auditing costs kept at a reasonable level, but what we've experienced in the past few years is the costs when internal controls fail. We're willing to pay a little bit to have internal controls done the right way."[28] An example of the costs when internal controls fail is seen in the recent collapse of Imergent. As shown in the chart below, the Company's share price fell from $25 to $8 in the last 6 months, a $187.7 million cost to investors. This comes after two separate lawsuits alleged business misconduct and the Company revealed that its revenue recognition policies were inappropriate, a strong indicator weaknesses in internal controls existed. This one instance of shareholder loss almost single handedly makes up for the $217.2 million aggregate increase in audit fees reported by close to 4,000 public companies under $100 million in revenues. (Table 4).

Chart 5: Imergent's Recent Fall Cost Investors $187.7 Million



Source: Glass Lewis, Yahoo! Finance.

Compared to the $310.8 billion loss in market capitalization of 30 companies with revenues under $100 million shown in Appendix A, we believe a couple hundred million dollar increase in audit fees is a good investment in the capital markets to help prevent such losses in the future.

[28] Los Angeles Times, July 30, 2003.

Would you support a total exemption from SOX Section 404 requirements for smaller companies? Why or why not?

Glass Lewis does not support an exemption for small companies. As stated before, small companies should not be exempt or held to lower standards and become "second class citizens." Lower standards or exemptions lead to a higher cost of capital and create greater risk for investors.

Would such an exemption have a negative effect on investors' interests or perception regarding smaller companies? Why or why not?

We provide research to investors that manage over $8 trillion in assets. We believe it would be appropriate to identify small companies that carry a higher degree of uncertainty due to less protections afforded for investors. Accordingly, we believe investors would be well advised to either assess a higher risk premium when providing capital, or avoid such investments as higher returns could be earned without taking on the additional risk. As we have stated before, the markets already have made the decision to take this action as many small businesses cannot attract institutional investor capital or analyst coverage. Greg Farrell noted in his book, *America Robbed Blind – How Corporate Crooks Fleeced American Shareholder*, "the vast majority of 14,000 publicly traded companies in the U.S. do not have analysts tracking their earnings and operations."[29] A lack of investor interest makes it difficult for smaller companies to attract analyst coverage or liquidity in their markets. In essence, the marketplace has spoken and the SEC would be well advised to consider what the marketplace has said. Further exempting smaller companies from rules designed to protect investors will only further exacerbate the problem, causing greater uncertainty and lack of confidence in them by investors.

Accounting/Auditing

15. Has SOX affected the relationship of smaller companies with their auditing firms? If yes, how? Is the change positive or negative?

The SOX legislation itself has not affected the relationship of smaller companies with their auditing firms. Well controlled companies typically have good relationships with their auditor. Companies with internal control problems including issues surrounding the quality of management do not.

As noted in the attached report, 1,609 companies, including 1,323 companies with market capitalization of under $100 million changed auditors in 2004.[30] Through June 30, 892 companies, including 657 with under $100 million in market capitalization, have changed auditors in 2005. We note that 30% of the companies reporting a material weakness in internal controls between January 1, 2004 and June 30, 2005 changed auditors.[31] We also noted 117 (19% of the total) companies reporting a restatement in 2004 reported a change in auditors. Many smaller accounting firms have benefited from these changes in auditors, at least in the short term.

It is also significant that small accounting firms who often audit small companies have a restatement rate two to three times higher than the eight largest accounting firms. It is reasonable to expect as companies have failed to invest adequately in their internal controls, resulting in errors in their financial statements, and exposed audit firms to additional risks and costs, that additional stress in the relationships between management and the auditors would occur.

16. Are the current accounting standards applied to all U.S. companies appropriate for smaller companies? If not, please explain what revisions to existing standards might be appropriate.

Yes. To facilitate investors' ability to make informed investment decisions based on accurate information to maximize the returns on invested capital, transparency in financial reporting is needed regardless of the size of the company. This requires all companies to disclose and account for similar transactions in a comparable fashion.

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[29] America Robbed Blind – How Corporate Crooks Fleeced American Shareholders, Greg Farrell, Wizard Academy Press, 2005, p. 147.

[30] Glass Lewis and Company Trend Alert: Auditor Turnover Gains Momentum in 2004, February 2005.

[31] Source: Glass Lewis. Between Jan. 1, 2004 and Jun. 30, 2005, 1,098 companies disclosed material weaknesses, of which 327 companies changed auditor in 2004 or 2005.

Over the course of the past four decades, some have urged that a system of "Big GAAP" and "Small GAAP" be established. However, as we saw with many of the dot.coms, a lack of transparency contributes to a lack of market discipline, ineffective utilization of capital, and ultimately a "bubble" with disastrous impact on capital markets. In today's capital markets, with over 90 million Americans participating, the effects of inadequate transparency can become even more pronounced, particularly with respect to the investing public.

It is also important to note while small companies may not have the available resources large companies often do, they also do not always enter into some of the complex transactions large companies do to manage risks, or as diverse a geographic set of transactions, which has a positive impact on costs. For example, a smaller company may not enter into foreign currency transactions, spanning numerous currencies around the globe, for both existing and anticipating transactions, such as IBM or Coca-Cola would.

17. For smaller companies, would extended effective dates for new accounting standards ease the burden of implementation and reduce the costs in a desirable way? How would such extensions affect investors or markets? Would allowing a company's independent auditors to provide more implementation assistance than they are able to currently reduce such burdens or costs? Would such a step positively or negatively affect the quality of audits? Please explain

We believe the Financial Accounting Standards Board has provided reasonable effective dates for implementation of new accounting and disclosure standards. The effective dates for such standards are part of their due process deliberations and subject to the public comment process. At Glass Lewis, we have been able to implement new standards without undue burden or costs.

Extension of effective dates for new accounting standards, such as those adopted for expensing of stock options or off -balance sheet special purpose entities, would result in investors receiving less transparent, less timely or perhaps even misleading financial statements. It also contributes to confusion in the marketplace and impairs investors' ability to compare companies. This lack of transparency results in the capital market participants receiving poorer quality information, which in turn can affect the quality of investment decisions made. For example, when Enron was able to avoid consolidation of special purpose entities, it contributed to a lack of understanding of Enron's exposure to off-balance sheet debt that could impact its cash flows and ultimately its stock values.

Having an independent party examine the financial statements prepared by management is critical to the integrity of the financial information provided therein, as well as investors' confidence in them. When auditors assist management in preparing the financial statements, the objectivity of an unbiased, independent third party is lost. In some cases, the independent auditors who have assisted management did so by providing assistance in financial engineering transactions to circumvent accounting rules that provide transparency. For example, the SEC Accounting & Auditing Enforcement action against PNC provides a clear example of the improper use of special purpose entities.[32] Investors have suffered losses as a result of such actions.

We believe the current SEC auditor independence rules permit sufficient latitude to auditors to provide advice to the companies whose financial statements they are auditing. Two members of our staff serve as audit committee chairs of public companies and we believe auditors can and do provide useful advice without compromising their independence.

On the other hand, we also strongly believe management or external advisors who provide consultation and advice on accounting matters, of which there are many, must prepare and take responsibility for the financial statements. We are troubled by companies who take money from the investing public, and yet later on state they lack resources and/or competent personnel to prepare financial statements in accordance with GAAP. All too often we have heard executives who blame auditors and fail to take the primary responsibility for errors in their financial statements, when the responsibility is that of the executives. In some cases, we have seen members of management say "sue the auditors, not us" as these executives shirk their responsibilities and try to avoid accountability.

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[32] SEC Accounting and Auditing Enforcement, Release No. 1597, July 18, 2002. "In 2001, PNC endeavored to remove certain loans and venture capital investments from its financial statements by transferring them to certain entities that were specially created to receive these assets and in which PNC held a substantial interest. In fact, none of the [off-balance sheet] transactions complied with these GAAP requirements for nonconsolidation of special purpose entities."

Accordingly, we would oppose changes to the existing auditor independence rules.

The Advisory Committee is particularly interested in responses to questions 18-20 from companies with a market capitalization of $100 million or less.

18. Would auditors providing assistance with accounting and reporting for unusual or infrequent transactions impair the auditors' independence as it relates to smaller companies? Would providing such assistance reduce the cost of compliance for smaller companies? What would be the impact on the quality of audits, investors or markets? Please explain.

We believe the securities laws and related rules and regulations make it clear it is the responsibility of management to ensure the financial statements provided to investors are prepared in accordance with applicable rules. There is no special exemption for unusual or infrequent transactions.

We believe existing auditor independence rules, Statement on Auditing Standard No. 97 and AU Section 625, *Reports on Applications of Accounting Principles*, are clear: auditors can provide their views on the proper accounting for a transaction.[33] However, the financial statements are those of management and not of an independent auditor. It is management who must ensure they have employees competent to conclude as to whether the accounting for a transaction is proper or not. Likewise, when an auditor issues an opinion on the financial statements, they are to reach an *independent* conclusion on whether the accounting and disclosures made by management are appropriate. And we believe that in many instances, when properly done, the conclusions reached by management and by the independent auditors, are not done without interactive discussions. We also note the American Institute of Certified Public Accountants, SEC Practice Section, has published "Best Practices – Accounting Consultations, Communications with Baord of Directors/Audit Committees, Communications with the SEC Staff" which provides excellent guidance on these topics.[34]

We are strong proponents of the current SEC rules, which do not prohibit companies from obtaining appropriate accounting advice from their auditors. Ultimately, management is responsible for the financial statements. A company needs to have the internal competence necessary to properly account for transactions. Companies that possess these skills and controls are easier to audit, provide greater transparency to investors and have greater access to capital markets.

19. Is the quarterly Form 10-Q or Form 10-QSB information valuable to users of the financial statements of smaller companies? Would a system that required semi-annual reporting with limited revenue information provided in the other quarters reduce costs of compliance without decreasing the usefulness of the reported information to investors? Please explain.

Yes, we use the data in the interim quarterly reports extensively. The data provides good insights into the ability of management to accomplish what they have previously told investors they would. It also provides important data on developing trends that will affect the value of a company's stock and public debt. A reduction in available information would be a disservice to investors.

20. Is segment information useful for smaller companies? Please explain.

Segment information is currently based on data used by a management team to manage the business. As such, management has already implied the information is important to the company being successful.

We also find segment information to be very useful in assessing the accomplishments and future success of a business and its management team. Often this information presents differing rates of growth, margins and profitability to investors. To eliminate it would, of course, hide information from investors they currently have. Management deems segment information necessary as well. It would be a significant step backwards for the SEC to adopt such an approach in light of its longstanding position. Management owes it to their investors to provide

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[33] SAS No. 97, Reports on Applications of Accounting Principles.

[34] AICPA SEC Practice Section, Best Practices – Accounting Consultations, Communications with Board of Directors/Audit Committees, Communications with the SEC Staff.

enough information for investors to see the company through "the eyes of management." Eliminating segment information would be akin to putting a blindfold over one eye.

21. Should accounting standards provide smaller companies with different alternatives for measuring accounting events that would reduce the amount of time that would otherwise be spent by smaller companies to comply with those accounting standards? If these alternatives were available to smaller companies, would smaller companies take advantage of them even if the results of the measurements obtained from the alternatives were less favorable to them in the short term? Why or why not?

Accounting in financial statements should reflect the actual economics of an accounting transaction, with adequate disclosure to ensure transparency. We believe this simple principle should apply to all companies, regardless of size.

Yet, when companies are allowed to use alternative accounting methods for the same transaction, one of those companies cannot be portraying the true underlying economics of the transaction. As such, we believe when that occurs, regardless of the size of the company, investors are being mislead. In addition, it also makes it impossible in most instances to make comparisons between companies when making an investment decision.

Comparability has been one of the fundamental principles of financial reporting in the U.S. capital markets. It provides investors the ability to weigh which companies have performed the best, and which ones are likely to do so, by permitting "apple to apple" comparisons. This in turn has established a system facilitating informed investment decisions to maximize investors' returns, thereby attracting the majority of the world's capital to the U.S. capital markets. In fact, as can be seen from the table below, the capital in the U.S. markets dwarfs the amount of capital attracted by other markets.

Table 5: Market Capitalization of Domestic Companies by Exchange

Market Capitalization *($ trillions)*	6/30/2005	6/30/2004	12/31/2004
Domestic Listed Companies (excluding closed-end funds - official WFE figures) of which:	$36.80	$32.30	$37.30
NYSE	$12.90	$11.60	$12.70
Nasdaq	$3.40	$2.90	$3.70
Tokyo Stock Exchange	$3.40	$3.40	$3.60
London Stock Exchange	$2.70	$2.50	$2.80
Euronext	$2.30	$2.10	$2.40
Deutsche Borse	$1.10	$1.10	$1.20
AMEX	$0.09	$0.10	$0.08

Source: NYSE. Note: WFE includes 50 exchanges, plus Nasdaq.

Companies with market capitalization less than $750M make up approximately 76% of the total public equity market in terms of number of companies.

Table 6: Size of the U.S. Public Equity Market (August 2005)

Population	Number of Companies	Aggregate Market Capitalization *($ billions)*	Market Cap. As % of Total Market Cap.	Number of Cos. as % of All Public Cos.
S&P 500	500	$11,329.5		
Russell 3000	3,000	$14,725.3		
All Public Companies	13,030	$29,373.4		
Market Capitalization:				
More than $750M	3,062	$28,383.3	97%	24%
$75M to $750M	3,133	$898.9	3%	24%
$25M to $75M	1,448	$65.8	0%	11%
Less than $25M	5,387	$25.3	0%	41%

Source: FactSet, Standard & Poor's, Russell, Glass Lewis. Note: All Public companies includes companies traded on NYSE, Nasdaq, AMEX, and OTCBB.

Corporate Governance/Listing Requirements

22. Are the listing standards of the New York Stock Exchange, the American Stock Exchange, other exchanges or Nasdaq that require a majority of independent directors and independent audit, nominating and compensation committees (or in the alternative, in the case of Nasdaq, that nomination and executive compensation decisions at a minimum be recommended or determined by a majority of the independent directors) creating a hardship for smaller companies? Are there benefits to companies and investors of these listing standards in the context of smaller companies? Do the hardships outweigh the benefits in the case of smaller companies? If so, should these standards be revised for smaller companies, and, if so, how? In each case please explain.

Shareholders, the owners of the company, elect directors to hire, monitor, compensate and, if necessary, terminate senior management. For directors to effectively carry out those responsibilities they must be independent of the company management they oversee. Independent directors who ask tough, relevant questions improve the quality of corporate governance. As such, we believe they provide a significant level of integrity to the system and confidence for investors. As has been previously cited, CEO's and CFO's in small public companies have been active participants in fraud.

Qualified independent directors also serve a key control function, especially when they serve on audit, nominating and compensation committees. If the requirement for independent directors is eliminated for these committees, then that important oversight role would be significantly weakened, possibly contributing to material weaknesses or inappropriate compensation decisions. When this higher level of risk exists, we believe investors should require a significantly higher return on their investment to compensate for the risk.

In addition, we note the FEI has compiled a list of qualified independent directors which many companies apparently have failed to avail themselves. Accordingly, we question whether the issue for some companies is one of independent board members or one of management who does not like tough, relevant questions asked by outsiders. In light of the numerous restatements and frauds among small public companies, we believe in some cases it is more of the latter than the former.

Are smaller companies experiencing difficulty finding independent directors to satisfy these listing standards (including independent directors with the required level of financial literacy and sophistication for audit committee service)? What steps are being undertaken to meet these requirements?

We believe the FEI list of available qualified directors is a prime example of unused talent. This clearly indicates the issue is not one of availability of talent, but one of whether or not a board should be comprised of those the CEO wants. In addition, we have spoken to several qualified individuals who have approached boards, and been turned down, ostensibly because the CEO or other board members want people they know and perhaps believe will vote with them. Easing of controls will increase the risk to directors and make it more difficult for companies to find qualified directors.

23. Other than director independence and concerns related to SOX Section 404-mandated internal controls, do you believe other aspects of governance and disclosure reform are unduly burdensome for smaller companies, taking into account the benefits they provide to investors and markets? If so, please explain which items are unduly burdensome and the extent of such burden. How could the burdens be appropriately ameliorated?

We believe the benefits of other aspects of corporate governance and disclosure provide investors significant benefits, increasing their confidence in the integrity of smaller cap companies, and as such, providing significantly greater benefits than any related costs. In light of recent accounting irregularities and the increasing number of restatements, we feel the SEC should be skeptical of efforts to weaken these protections, maintaining its highest priority of investor protection.

24. Is the loan prohibition contained in SOX creating a hardship for smaller companies? If so, explain the manner in which this hardship is being created. Do the benefits to companies and investors outweigh the hardships? Should the prohibition be clarified to exclude certain types of transactions where conflicts of interest or a likelihood of abuse may not be present?

My Big Fat Corporate Loan, a 2002 survey of the 1,500 largest companies in the country, found these companies had made executive loans aggregating $4.5 billion, an average of $10.7 million per loan.[35] To say these executives were using public company treasuries as their personal piggy bank is an understatement. In a follow-up survey in January 2004 entitled *The Low-Carb Corporate Loan*, in 50 of these companies it was found only 12 had ensured the debt was paid-off.[36]

Loans to executives were often done in the past, not to create value for shareholders, but rather to provide greater financial rewards for executives. Often this came at a cost, rather than a benefit to investors. We also note in many instances these loan programs were not broad-based but done solely to benefit certain key executives.

We do believe, when attempting to attract a key employee, making a loan to facilitate their ability to move and find new housing makes sense. Accordingly, we believe, if loans were permitted ONLY for this limited exception, and (1) were required to be made using market rates and terms, (2) the independent members of the board of directors found it to be in the best interest of investors, and (3) the board was required to disclose their decision as well as any default on the loan, we would support permitting these loans.

Disclosure System

25. Is the relief provided by SEC Regulation S-B meaningful? Why or why not?

We believe the current system has established Regulation S-B filers as second class citizens. All too often we have been asked questions about the credibility and integrity in such filings. As a result, we believe this contributes to difficulties in obtaining a following by analysts, and perhaps a difficulty in attracting directors given the "stigma" attached to such filings.

Glass Lewis does not support an exemption for small companies. As stated before, small companies should not be exempt or held to lower standards and become "second class citizens." Lower standards or exemptions lead to a higher cost of capital and create greater risk for investors.

Should the SEC provide an alternative disclosure framework for smaller companies in the context of securities offerings and periodic reporting? Should the alternative framework be available to a broader category of companies than Regulation S-B is currently? Should the alternative framework be based on Regulation S-B or on a different approach? Could these steps be taken without impairing investor protection?

Creating alternative frameworks is the first step in the reduction of financial reporting and disclosure quality. Alternative frameworks would also create unnecessary confusion for the investing public. A framework that reduces transparency and investor protection will be one potential precursor that contributes to the creation of the next stock market bubble and corresponding crash similar to 2000.

26. Are the costs of preparing and distributing printed paper versions of proxy statements and annual reports to shareholders unduly costly for smaller companies? Describe the extent of such costs, and the amount that could be saved if the SEC allowed complete electronic delivery of documents.

We believe investors should be allowed to make this decision. To the extent investors would prefer to receive filings and reports electronically, we believe they should be permitted to do so. However, one must also be cognizant there are a significant percentage and number of investors who are over age 65 and did not grow up in the electronic age, who do not utilize computers in the same manner as new graduates from college today. For this segment of the population, and others who wish to receive printed paper versions of proxy statements and annual reports, they should be permitted to continue to receive paper filings and reports.

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[35] My Big Fat Corporate Loan, Paul Hodgson, The Corporate Library, December 2002.
[36] The Low-Carb Corporate Loan, Paul Hodgson, The Corporate Library, January 2004.

27. Will the phase-down to the final accelerated reporting deadlines for periodic reports under the 1934 Act for companies with $75 million market capitalization (ultimately 60 days for Form 10-K and 35 days for Form 10-Q) be burdensome for smaller companies? If so, please explain the manner and extent of this burden. Does the burden outweigh benefits to investors and markets for smaller companies?

We find it simply amazing companies in today's age of technology, who want to send out all their filings electronically, can't even close their books and get the necessary financial reports and filings done within two months of year end or a month after the close of their quarter ends. The SEC recently instituted a public administrative proceeding against 20 smaller companies that failed to make required periodic filings. The Division of Enforcement found that each company was at least one year delinquent with its periodic filings with the Commission.[37] Long before SOX was passed, in the first enforcement "sweep" by the SEC in September 1999, the Commission took action against 68 companies and individuals, many of which the targets were small companies, for engaging in fraud and related misconduct in the accounting, reporting, and disclosure of financial results.[38] In addition, we note 136 of the 442 late filers in 2004 (31%) were companies with market capitalization less than $100M. We also believe this indicates these companies lack the necessary systems to be public companies and is also indicative of why poor systems and a lack of competent personnel are leading reasons for material weaknesses in internal controls.

In general, smaller companies lack the complexity of larger companies. We suggest an alternative and better proposal would be to require small public companies be permitted to use a 75 day filing deadline for their annual report, and a 40 day filing deadline for their Form 10-Q, but ONLY if they file their reports within 10 and 5 business days, respectively, of when they file their annual and interim earnings release. We believe it is inconsistent that companies are able to publish their earnings releases and conduct their analyst calls, yet cannot generate their annual and quarterly filings within these time frames.

28. Should the current limit on the amount of securities that may be sold under Securities Act Rule 701 or the $5 million threshold that triggers an additional disclosure obligation under that rule be increased or modified in any way? Please explain.

It has been a number of years since these thresholds have been adjusted. Accordingly, we believe it would be appropriate to increase the $5 million limit to $7.5 million and index it to an inflation factor.

Miscellaneous

29. If there is any other matter relating to the securities laws applicable to smaller companies that you wish to comment on or to bring to the Advisory Committee's attention?

We believe while this committee may be well intentioned, its proposals appear to lack an understanding of the role of transparency and high quality financial reporting to the capital markets. As a result, we believe it is important the committee establish through independent research with verified results, the conclusions it reaches. We also believe many of its proposals will set the foundation for a lack of market discipline that could contribute significantly to the next stock market bubble.

We also note the SEC's annual report contains very little useful information for its readers regarding the role of small business in the U.S. capital markets. We would urge the SEC to provide investors and Congress with useful and significant information regarding capital information by small companies including:

1. The number of small and medium sized public companies and their aggregate market capitalization.
2. The number of small and medium sized companies conducting initial and secondary public offerings and the amounts of capital raised.
3. The number of small and medium sized companies delisted.

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[37] SEC Release No. 52020, July 13, 2005.

[38] SEC Release No. 99-124, SEC Charges 68 Individuals and Entities with Fraud and/or Abuses of the Financial Reporting Process, September 28, 1999.

Appendix A – Market Capitalization Losses of "Smaller" Companies

Even small companies, with revenues under $100 million, can be the source of considerable investor losses. During the "dot.bomb" era, 519 dot.coms, many of them small companies, died in 1999 and 2000. Another 384 fell by the wayside in 2001, a year in which 98,522 people were laid off from dot.coms.[1] Their fall and the stock market bubble, along with widespread corporate fraud, was one of the driving forces behind the SOX legislation.

As illustrated in this appendix, the types of companies which are currently targeted for deregulation by the SEC Advisory Committee on Smaller Public Companies contributed to investors losing hundreds of billions of dollars in market capitalization losses during the period from the inflated height of the bubble to the gutter of the last stock market bust. To relax the rules governing small companies now, just 3 years after an unprecedented crash, would be a tremendous disservice to investors and the U.S. capital markets.

A sample collection of a mere 55 smaller companies shown in Table A1, chosen for their various issues and relatively small size (as measured by revenue), combine for a total loss to investors of $342.4 billion during this period. Of the 55 companies that combined to cause more than a $340 billion investor loss, 41 of the 52 still in operation subsequently disclosed material weaknesses in their internal controls and/or restated previously issued financial statements. We believe the occurrence of material weaknesses and restatements, which is already high among smaller companies, would only become more prevalent if current regulation was softened for smaller companies, inflicting more, and perhaps greater, damage to investors as shown on the next page.

[1] Dead and (Mostly) Gone, Fortune, December 24, 2001, p. 46-47.

Table A1: Market Capitalization Losses at 55 "Smaller" Companies

Ticker	Company Name	Current Market Cap ($M)[1]	Market Cap High ($M)	Market Cap Low ($M)	Market Cap Loss ($M)	Revenue at High ($M)[2]	Issues[3]
ICGE	Internet Capital Group Inc.	$309.5	$52,716.0	$46.3	$52,669.7	$16.5	Bubble
INSP	InfoSpace Inc.	$821.5	$36,993.9	$117.0	$36,876.8	$56.8	Bubble
RBAK	Redback Networks Inc.	$491.2	$24,259.3	$14.4	$24,244.9	$91.9	Bubble
CMRCQ	Commerce One Inc.	$4.2	$20,335.6	$1.4	$20,334.2	$33.6	Restatement, Material Weakness, Bankruptcy Proceedings
SONS	Sonus Networks Inc.	$1,170.0	$15,932.0	$40.4	$15,891.7	$7.6	Restatement, Material Weakness
IIP	InterNAP Network Services Corp.	$159.4	$13,989.1	$20.0	$13,969.1	$12.5	Material Weakness
VITR	Vitria Technology Inc.	$115.0	$12,350.4	$69.1	$12,281.3	$30.3	Material Weakness
LBRT.PK	Liberate Technologies	$21.2	$10,743.0	$21.2	$10,721.8	$21.0	Restatement, Trading as Pink Sheet
AVNX	Avanex Corp.	$121.4	$10,731.8	$45.7	$10,686.1	$40.7	Bubble
KANA	Kana Software Inc.	$46.9	$10,319.5	$14.9	$10,304.6	$14.1	Material Weakness, Delinquent in Required Filings with SEC
OPTV	OpenTV Corp.	$360.2	$10,205.3	$54.1	$10,151.1	$26.0	Material Weakness
BKHM	Bookham Inc.	$141.5	$9,350.0	$52.3	$9,297.7	$17.8	Material Weakness
DVW	Covad Communications Group Inc.	$322.4	$9,189.6	$61.3	$9,128.3	$66.5	Restatement
FNSR	Finisar Corp.	$235.6	$8,969.3	$85.1	$8,884.2	$58.8	Restatement, Material Weakness
TERN	Terayon Communication Systems Inc.	$255.1	$6,796.1	$85.8	$6,710.3	$97.0	Material Weakness
WFII	Wireless Facilities Inc.	$400.7	$6,268.6	$165.2	$6,103.4	$92.7	Restatement, Material Weakness
WBVN	Webvan Group Inc.	NA	$5,868.9	$0.5	$5,868.4	$13.3	Delisted, dot.com
CPTH	Critical Path Inc.	$19.4	$5,479.8	$10.9	$5,468.9	$16.2	Restatement, Material Weakness, SEC Investigation, Justice Dept. Investigation
NUAN	Nuance Communications Inc.	$204.0	$5,328.4	$45.0	$5,283.4	$30.0	Restatement
RTHMQ.PK	Rhythms NetConnections Inc.	$0.0	$4,978.8	$0.0	$4,978.8	$2.7	SEC Investigation, Trading as Pink Sheet, Contributed to Enron Fraud
MSLV	MetaSolv Inc.	$125.7	$4,172.1	$32.1	$4,140.0	$73.0	Material Weakness
TTPA	Trintech Group PLC	$58.1	$3,793.1	$13.0	$3,780.2	$30.2	Other
NTIQ	Netiq Corp.	$631.7	$4,218.9	$467.7	$3,751.2	$70.9	Restatement
NTOP	Net2Phone Inc.	$151.4	$3,514.2	$119.4	$3,394.8	$33.3	Material Weakness
TMWD	Tumbleweed Communications Corp.	$160.8	$3,286.1	$22.8	$3,263.2	$15.3	Bubble
ENZN	Enzon Pharmaceuticals Inc.	$306.6	$3,470.8	$250.0	$3,220.8	$19.3	Restatement, Material Weakness
WJCI	WJ Communications Inc.	$78.6	$2,800.0	$32.7	$2,767.3	$79.9	Material Weakness
RSTN.PK	Riverstone Networks Inc.	$76.8	$2,543.2	$57.7	$2,485.5	$98.3	Restatement, Material Weakness, Trading as Pink Sheet
RCOM	Register.com Inc.	$191.4	$2,174.0	$108.5	$2,065.5	$21.3	Restatement, Material Weakness
VNWK	Visual Networks Inc.	$45.4	$2,073.6	$20.8	$2,052.9	$91.7	Restatement
				Sub Total Market Cap Loss	**$310,776.1**		

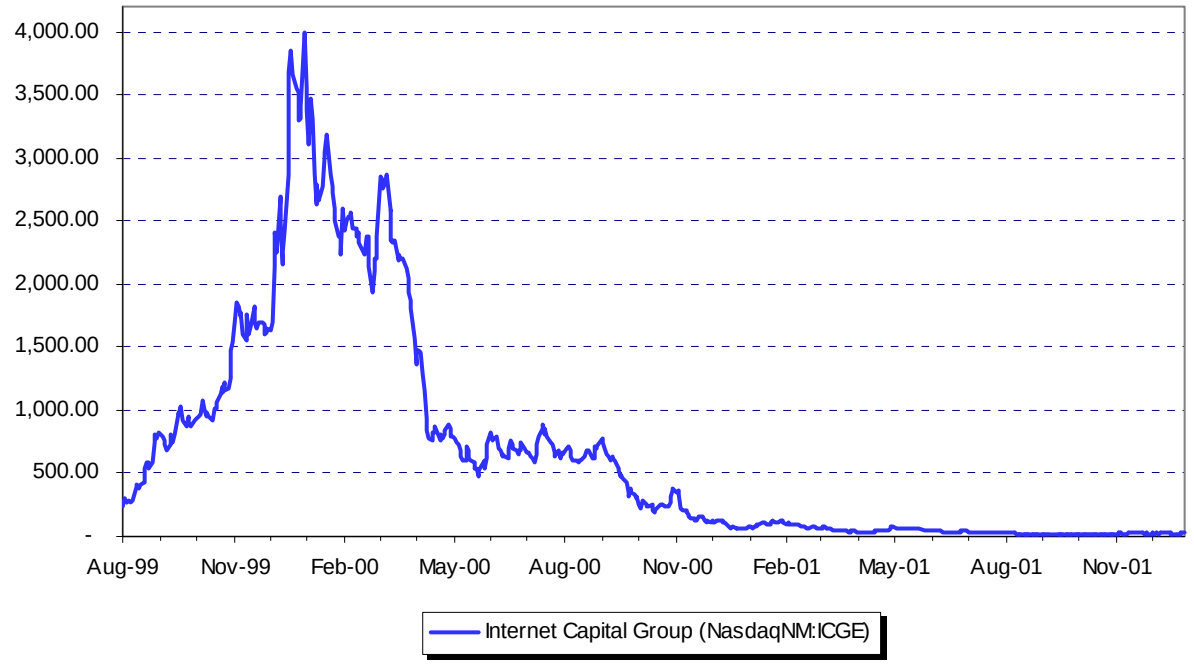
Source: Capital IQ, FactSet, Glass Lewis. Notes: (1) Current market capitalization as of 8/30/2005. (2) Revenue under $100 million for LTM at the date of market capitalization high. (3) Bubble indicates companies artificially inflated in the stock market without underlying business economics to validate such high valuation. Individual stock charts for each of the 30 companies are shown below tracking the rise and fall of these companies.

Table A1: Market Capitalization Losses at 55 "Smaller" Companies (continued)

Ticker	Company Name	Current Market Cap ($M)[1]	Market Cap High ($M)	Market Cap Low ($M)	Market Cap Loss ($M)	Revenue at High ($M)[2]	Issues[3]
ACTU	Actuate Corp.	$143.0	$2,055.0	$44.9	$2,010.1	$88.9	Material Weakness
BVEW	BindView Development Corp.	$157.4	$1,981.6	$37.6	$1,944.1	$71.7	Material Weakness
WGRD	Watchguard Technologies Inc.	$148.9	$2,009.7	$101.0	$1,908.7	$20.6	Restatement, Material Weakness
PRCS	Praecis Pharmaceuticals Inc.	$31.0	$1,931.1	$26.7	$1,904.4	$40.1	Restatement
NVEI	New Visual Corp.	$4.1	$1,901.4	$3.0	$1,898.4	$0.1	Material Weakness
BIZ	Dsl Net Inc.	$18.7	$1,860.9	$16.4	$1,844.6	$1.3	Restatement
TUTS	Tut Systems Inc.	$80.8	$1,803.8	$8.1	$1,795.7	$56.4	Restatement, Material Weakness
AMRI	Albany Molecular Research Inc.	$539.1	$2,012.8	$256.8	$1,756.0	$59.7	Restatement, Material Weakness
IPIX	Ipix Corp.	$103.4	$1,720.4	$5.5	$1,714.8	$12.5	Restatement
WEBM	webMethods Inc.	$363.9	$1,915.8	$210.2	$1,705.7	$39.4	Restatement, Material Weakness
BSQR	Bsquare Corp.	$19.8	$1,615.3	$15.3	$1,600.1	$41.4	Restatement
TFSM	24/7 Real Media Inc.	$248.5	$1,449.2	$4.0	$1,445.2	$90.0	Bubble
ZIXI	Zix Corp.	$78.1	$1,453.3	$41.5	$1,411.7	$0.1	Restatement
ANCCD	Airnet Communications Corp.	$17.7	$1,393.8	$12.1	$1,381.7	$17.8	Restatement, Material Weakness
COSN	Cosine Communications Inc.	$27.2	$1,287.1	$20.0	$1,267.1	$7.6	Material Weakness
ALSC	Alliance Semiconductor Corp.	$95.3	$1,224.5	$54.4	$1,170.1	$89.2	Material Weakness
KOOP	drkoop.com Inc.	NA	$1,090.1	$0.0	$1,090.1	$1.5	SEC Investigation, Delisted, dot.com
SLTC	Selectica	$104.3	$1,157.0	$73.0	$1,084.0	$10.6	Material Weakness
AVCI	Avici Systems Inc.	$58.5	$1,041.8	$28.7	$1,013.1	$2.7	Bubble
HTAC.PK	Healthtrac Inc.	$0.7	$1,011.0	$0.7	$1,010.3	$0.7	Restatement, Trading as Pink Sheet
IIG	Imergent Inc.	$97.0	$207.8	$4.4	$203.3	$9.4	Restatement, Fraud, SEC Investigation
USXX	U.S. Technologies Inc.	NA	$165.6	$0.0	$165.6	$3.8	SEC Investigation, Justice Department Investigation
FIMG	Fischer Imaging Corp.	$9.4	$156.6	$7.0	$149.5	$50.5	Material Weakness, SEC Investigation
FSCXQ	FastComm	$0.0	$106.9	$0.0	$106.8	$5.6	SEC Investigation
ITEX	Itex Corp.	$14.2	$23.2	$1.0	$22.2	$19.2	SEC Investigation
				Sub Total Market Cap Loss	**$31,603.3**		
				Aggregate Total Market Cap Loss of 55 Companies	**$342,379.5**		

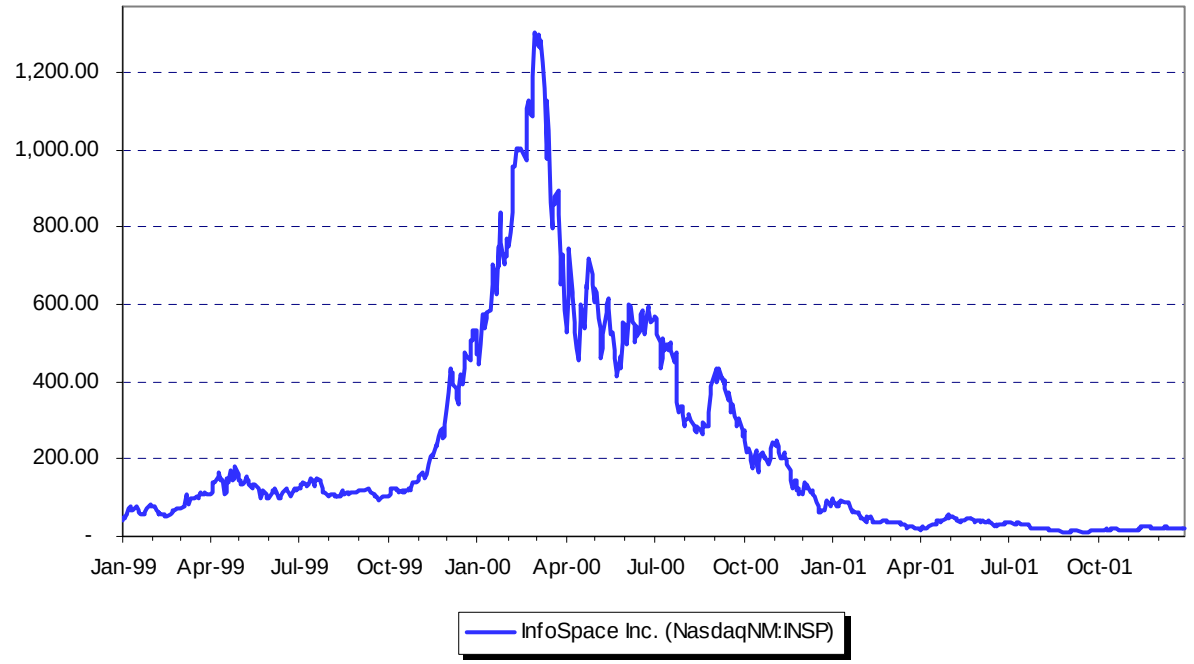
Source: Capital IQ, FactSet, Glass Lewis. Notes: (1) Current market capitalization as of 8/30/2005. (2) Revenue under $100 million for LTM at the date of market capitalization high. (3) Bubble indicates companies artificially inflated in the stock market without underlying business economics to validate such high valuation.

Chart A1: Internet Capital Group - $52.7 Billion Loss in Market Capitalization



Source: Capital IQ, Glass Lewis.

Chart A2: InfoSpace - $36.9 Billion Loss in Market Capitalization



Source: Capital IQ, Glass Lewis.

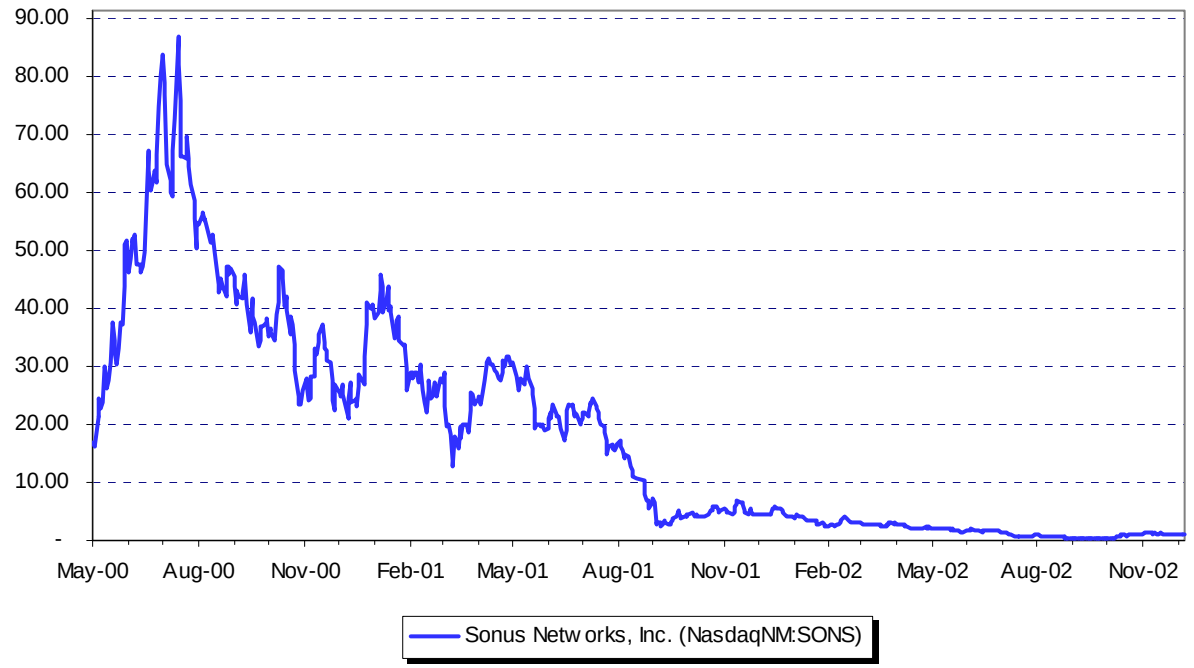
Chart A3: Redback Networks - $24.2 Billion Loss in Market Capitalization

Source: Capital IQ, Glass Lewis.

Chart A4: Commerce One (CO Liquidation) - $20.3 Billion Loss in Market Capitalization

Source: Capital IQ, Glass Lewis. Company announced a restatement on 5/26/2004 and a material weakness existed on 8/9/2004. Company restated results for 2003.

Chart A5: Sonus Networks - $15.9 Billion Loss in Market Capitalization

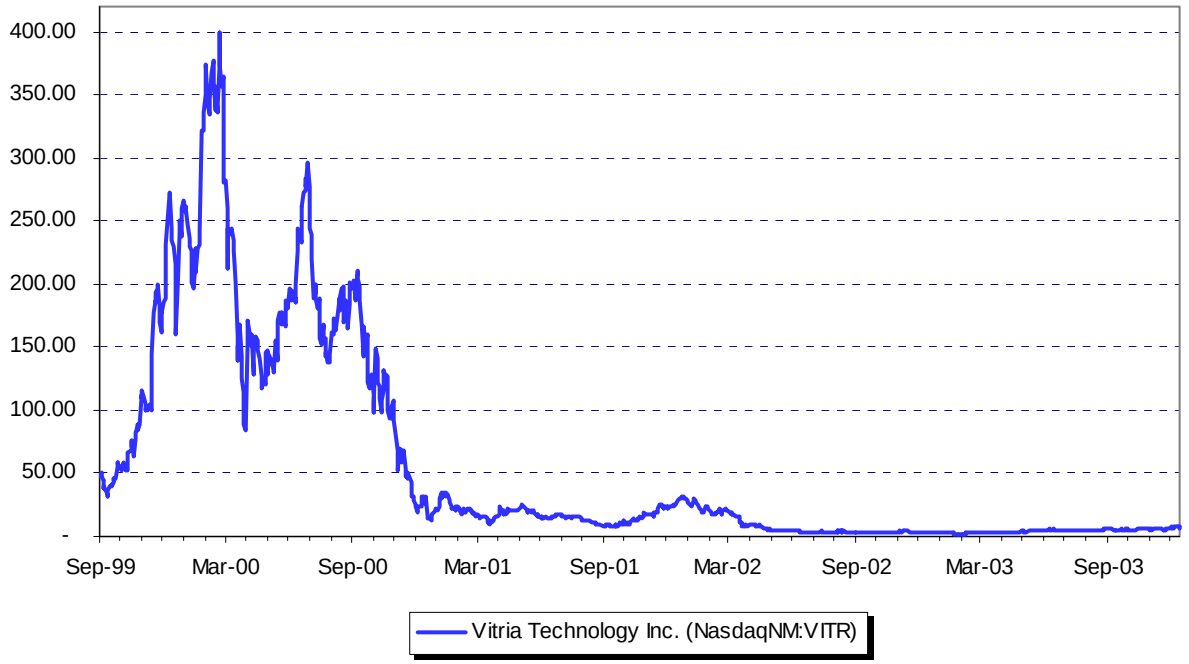


Source: Capital IQ, Glass Lewis. Company announced a restatement on 7/8/2004 and a material weakness existed on 3/15/2005. Company restated results for 2001-2003.

Chart A6: Internap Network Services - $14.0 Billion Loss in Market Capitalization

Source: Capital IQ, Glass Lewis. Company announced a material weakness existed on 3/1/2005.

Chart A7: Vitria Technology - $12.3 Billion Loss in Market Capitalization



Source: Capital IQ, Glass Lewis. Company announced a material weakness existed on 3/31/2005.

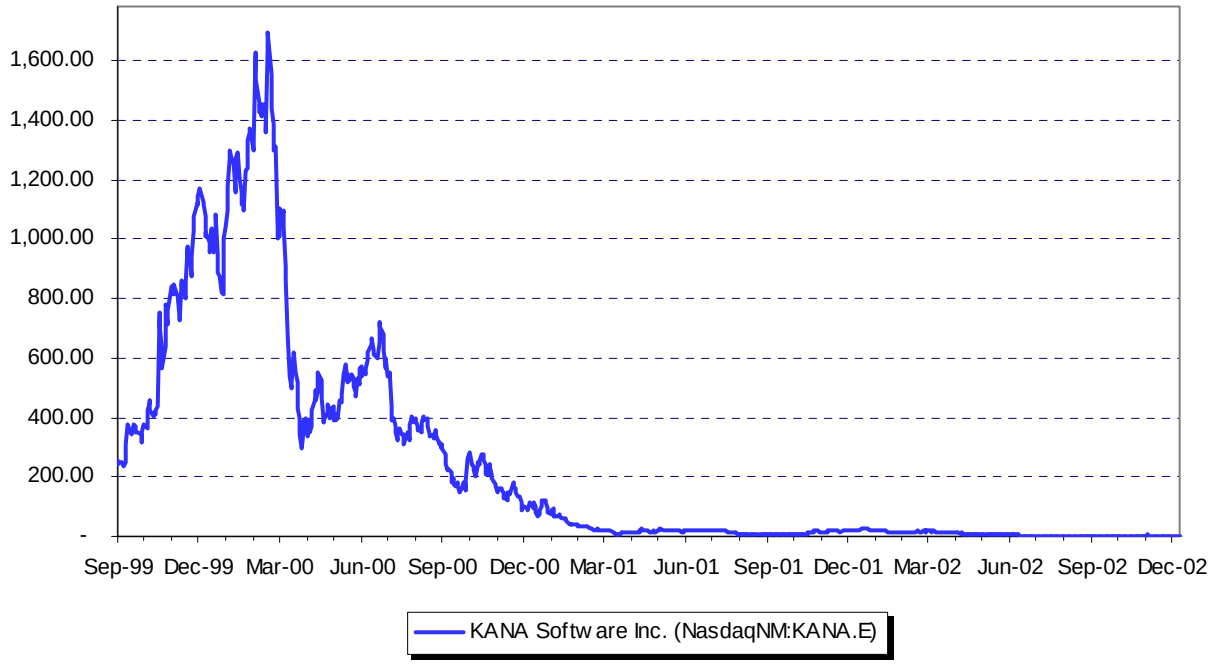
Chart A8: Liberate Technologies - $10.7 Billion Loss in Market Capitalization

Source: Capital IQ, Glass Lewis. Company announced a restatement on 10/15/2002. Company restated results for 2002-2003.

Chart A9: Avanex - $10.7 Billion Loss in Market Capitalization

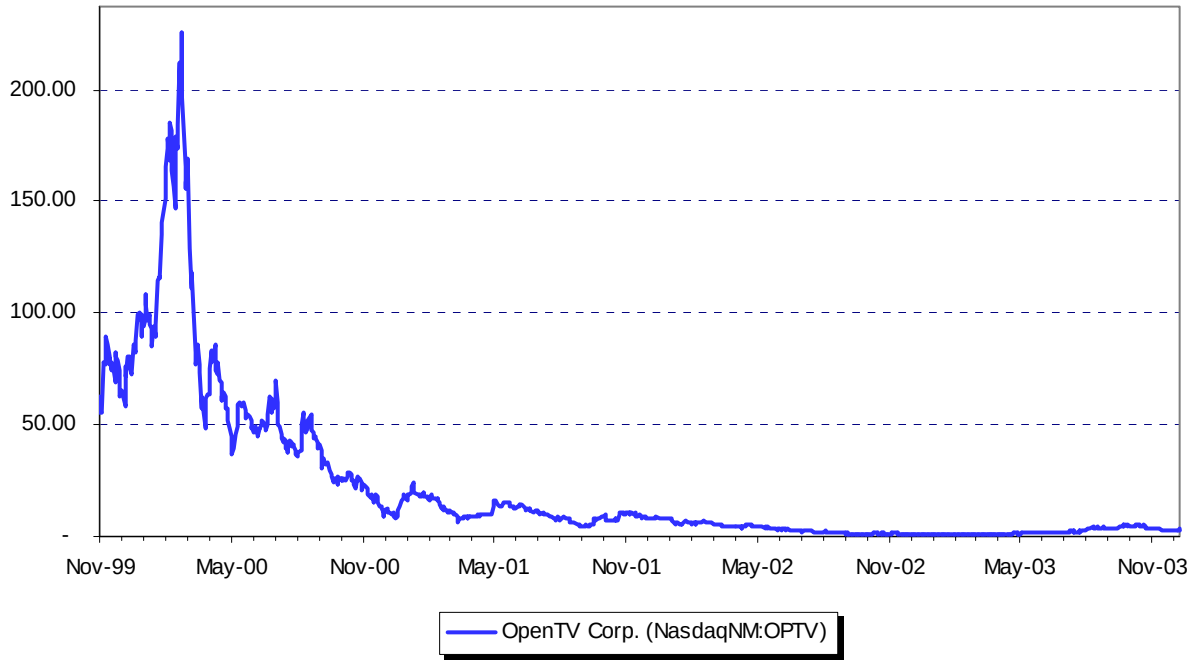
Source: Capital IQ, Glass Lewis.

Chart A10: Kana Software - $10.3 Billion Loss in Market Capitalization



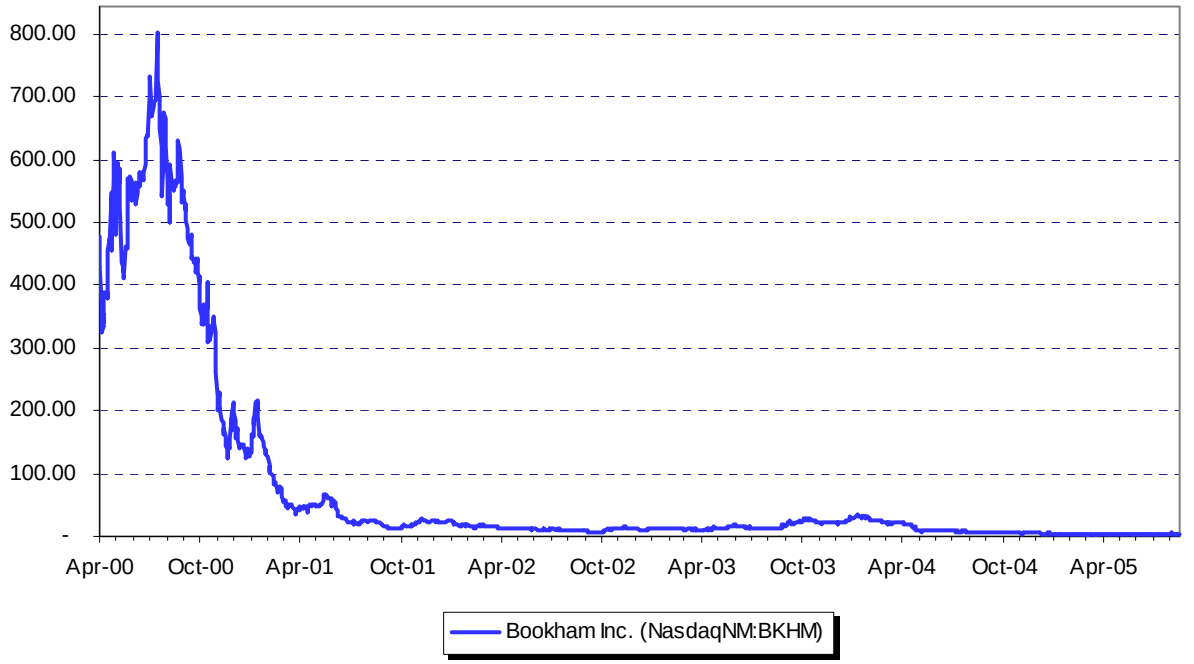
Source: Capital IQ, Glass Lewis. Company announced a material weakness existed on 8/26/2005.

Chart A11: OpenTV - $10.2 Billion Loss in Market Capitalization



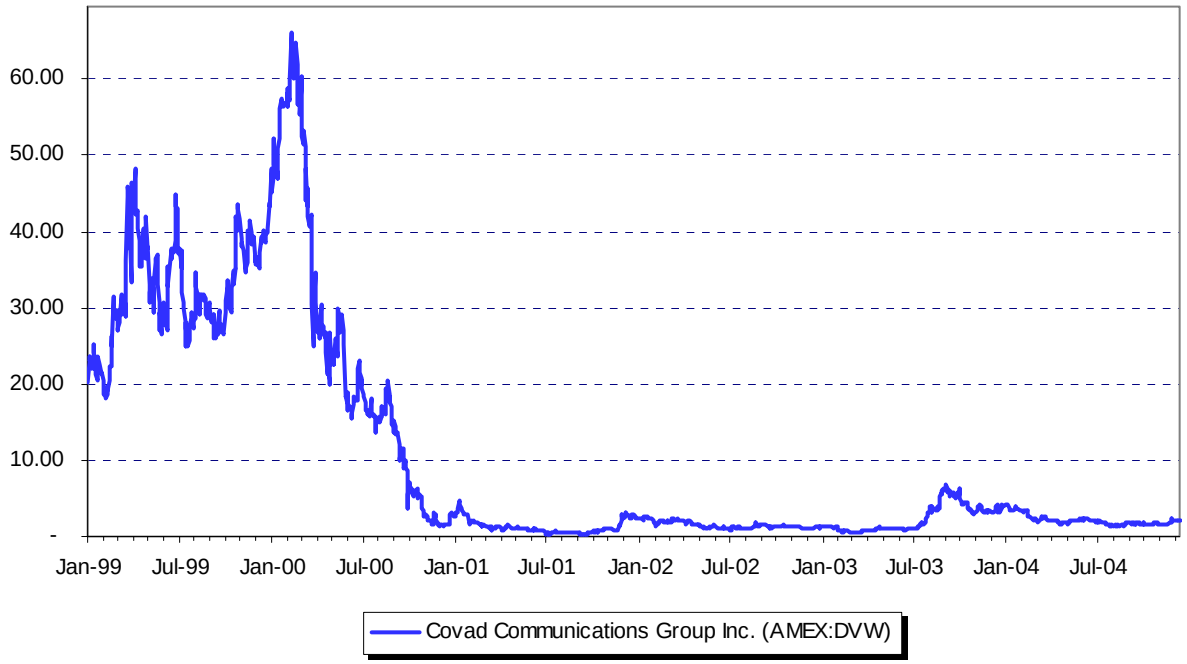
Source: Capital IQ, Glass Lewis. Company announced a material weakness existed on 3/16/2005.

Chart A12: Bookham - $9.3 Billion Loss in Market Capitalization



Source: Capital IQ, Glass Lewis. Company announced a material weakness existed on 11/12/2004.

Chart A13: Covad Communications - $9.1 Billion Loss in Market Capitalization

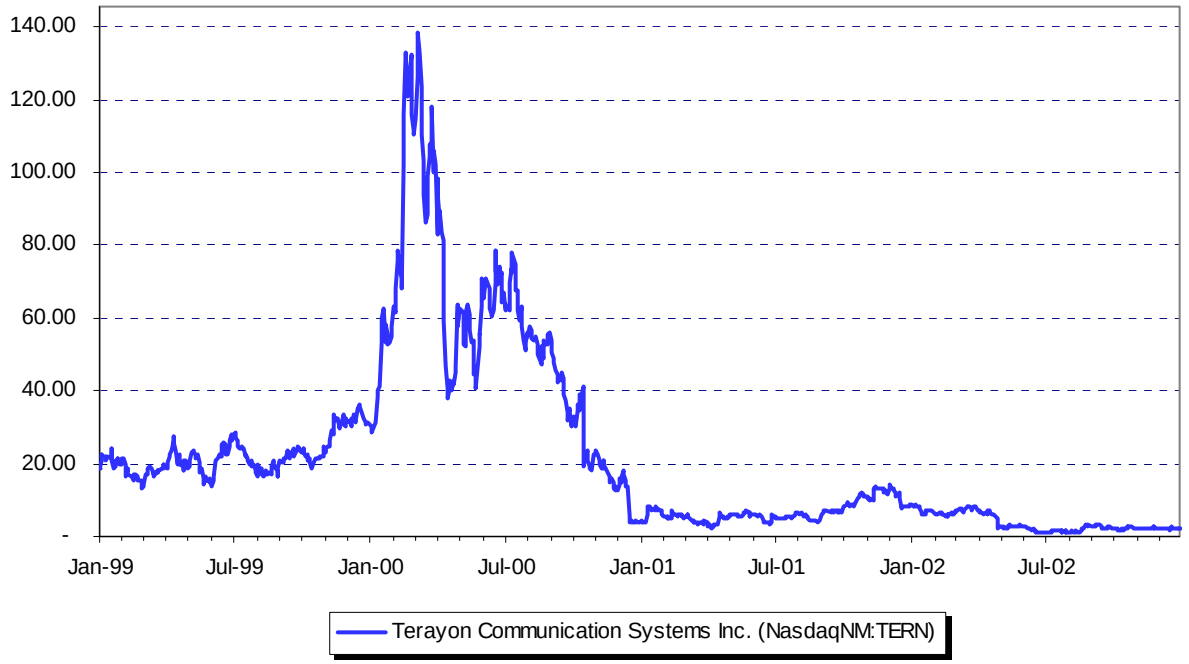


Source: Capital IQ, Glass Lewis. Company announced a restatement on 5/17/2004. Company restated results for 2000 and 2003.

Chart A14: Finisar - $8.9 Billion Loss in Market Capitalization

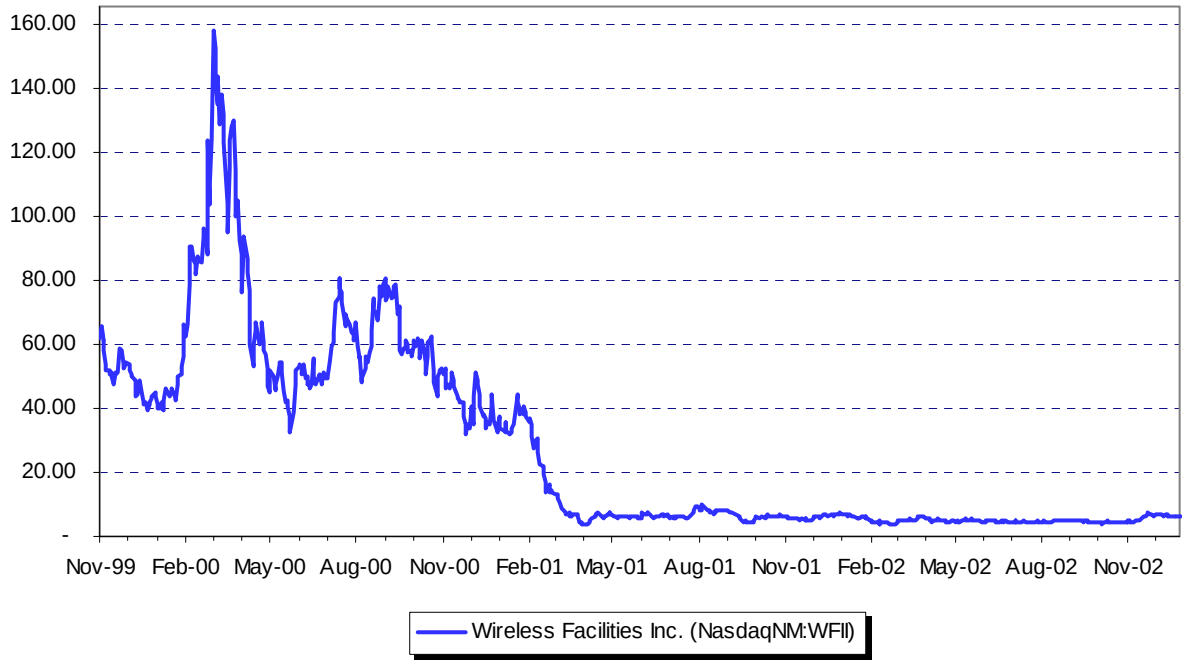
Source: Capital IQ, Glass Lewis. Company announced a restatement on 2/10/2005 and a material weakness existed on 2/8/2005. Company restated results for 2005.

Chart A15: Terayon Communication Systems - $6.7 Billion Loss in Market Capitalization



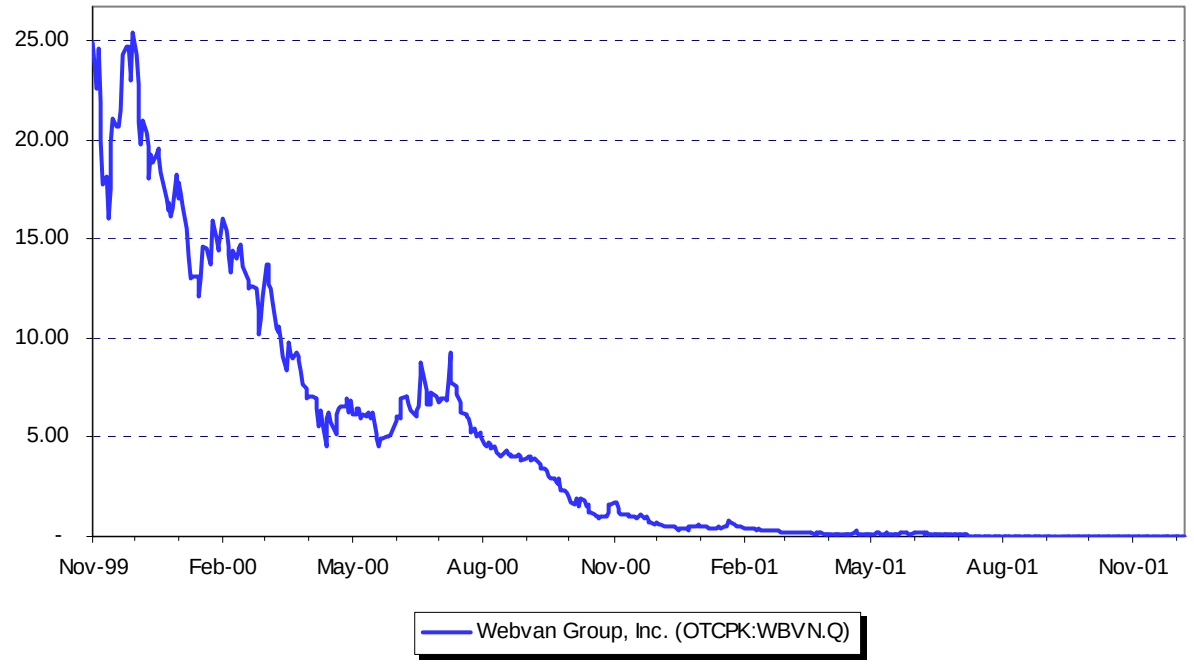
Source: Capital IQ, Glass Lewis. Company announced a material weakness existed on 3/15/2005.

Chart A16: Wireless Facilities - $6.1 Billion Loss in Market Capitalization



Source: Capital IQ, Glass Lewis. Company announced a restatement and a material weakness existed on 9/20/2004. Company restated results for 2000-2003.

Chart A17: Webvan - $5.9 Billion Loss in Market Capitalization

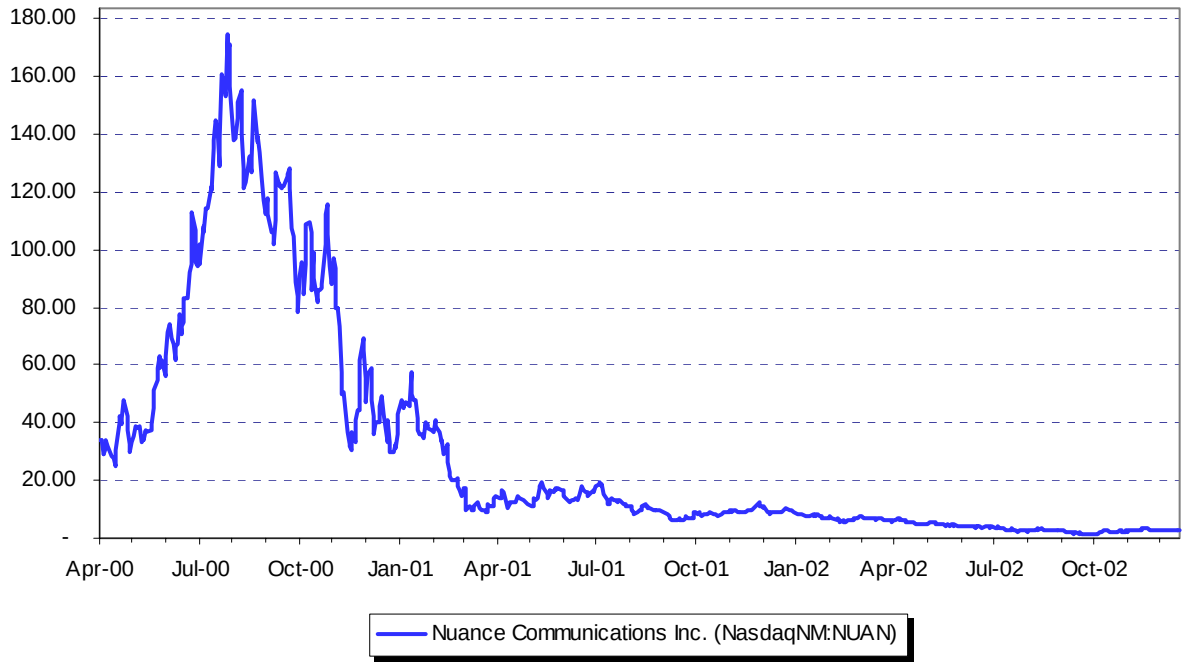


Source: Capital IQ, Glass Lewis.

Chart A18: Critical Path - $5.5 Billion Loss in Market Capitalization

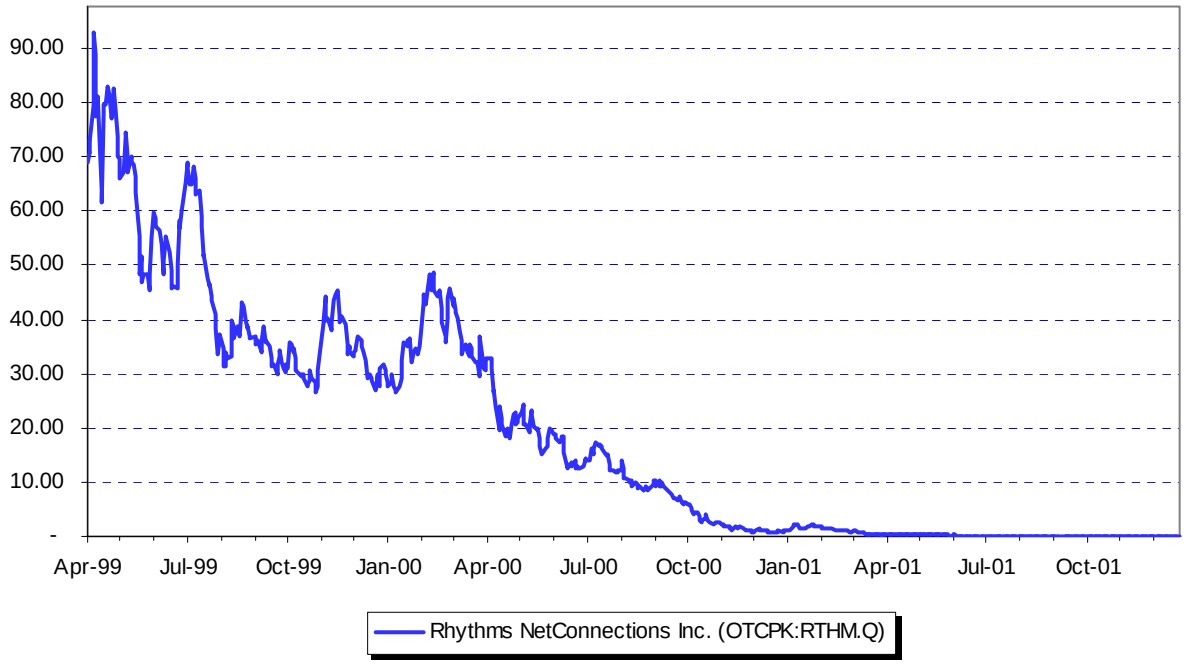
Source: Capital IQ, Glass Lewis. Company announced a restatement on 4/5/2001 and a material weakness existed on 2/24/2005. Company restated results for 2000.

Chart A19: Nuance Communications - $5.3 Billion Loss in Market Capitalization



Source: Capital IQ, Glass Lewis. Company announced a restatement on 11/9/2004. Company restated results for 2004.

Chart A20: Rhthms NetConnections - $5.0 Billion Loss in Market Capitalization

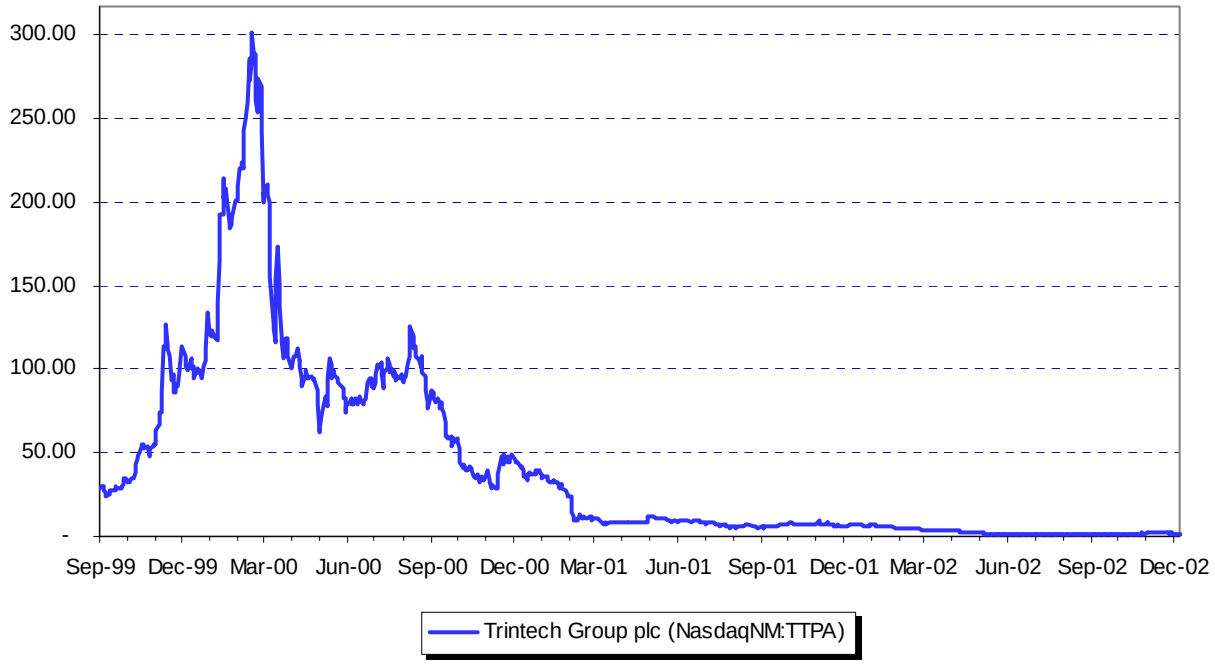


Source: Capital IQ, Glass Lewis.

Chart A21: MetaSolv - $4.1 Billion Loss in Market Capitalization

Source: Capital IQ, Glass Lewis. Company announced a material weakness existed on 3/31/2005.

Chart A22: Trintech - $3.8 Billion Loss in Market Capitalization



Source: Capital IQ, Glass Lewis.

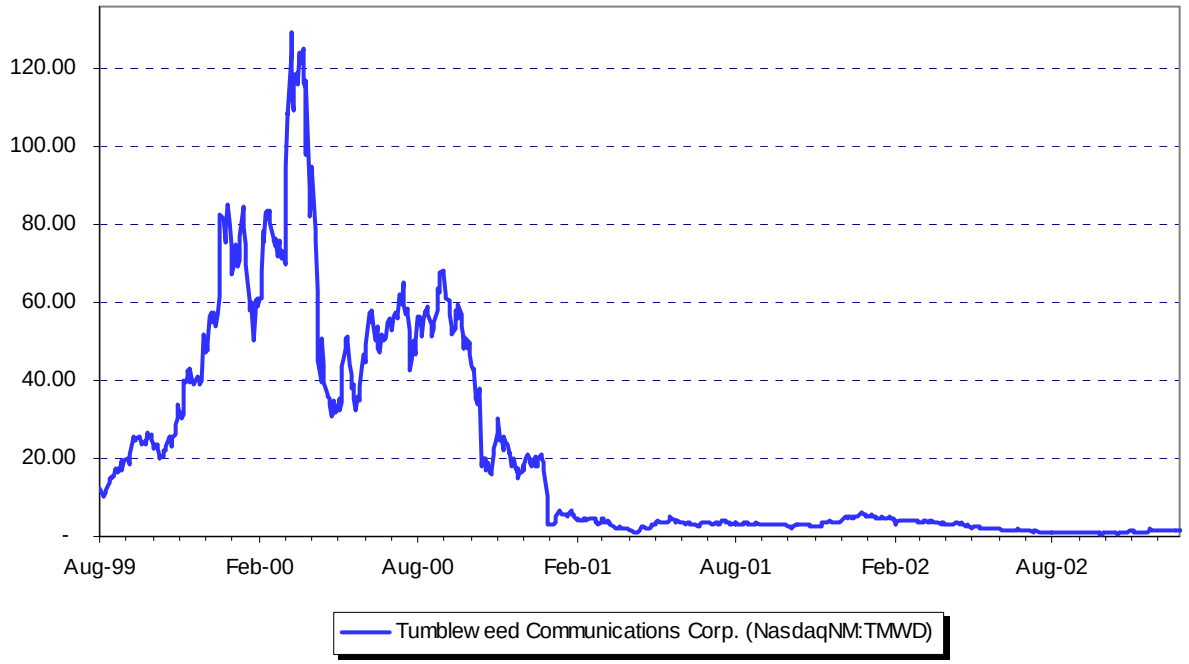
Chart A23: NetIQ - $3.8 Billion Loss in Market Capitalization

Source: Capital IQ, Glass Lewis. Company announced a restatement on 2/13/2004. Company restated results for 2004.

Chart A24: Net2Phone - $3.4 Billion Loss in Market Capitalization

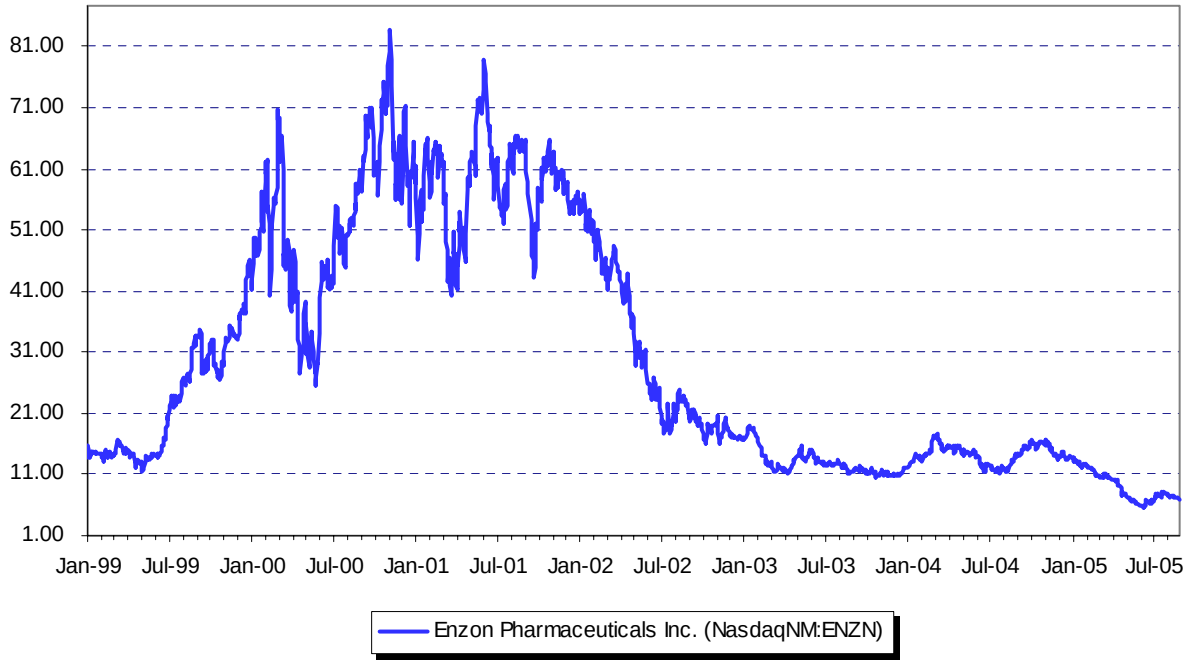
Source: Capital IQ, Glass Lewis. Company announced a material weakness existed on 3/9/2005.

Chart A25: Tumbleweed Communications - $3.3 Billion Loss in Market Capitalization



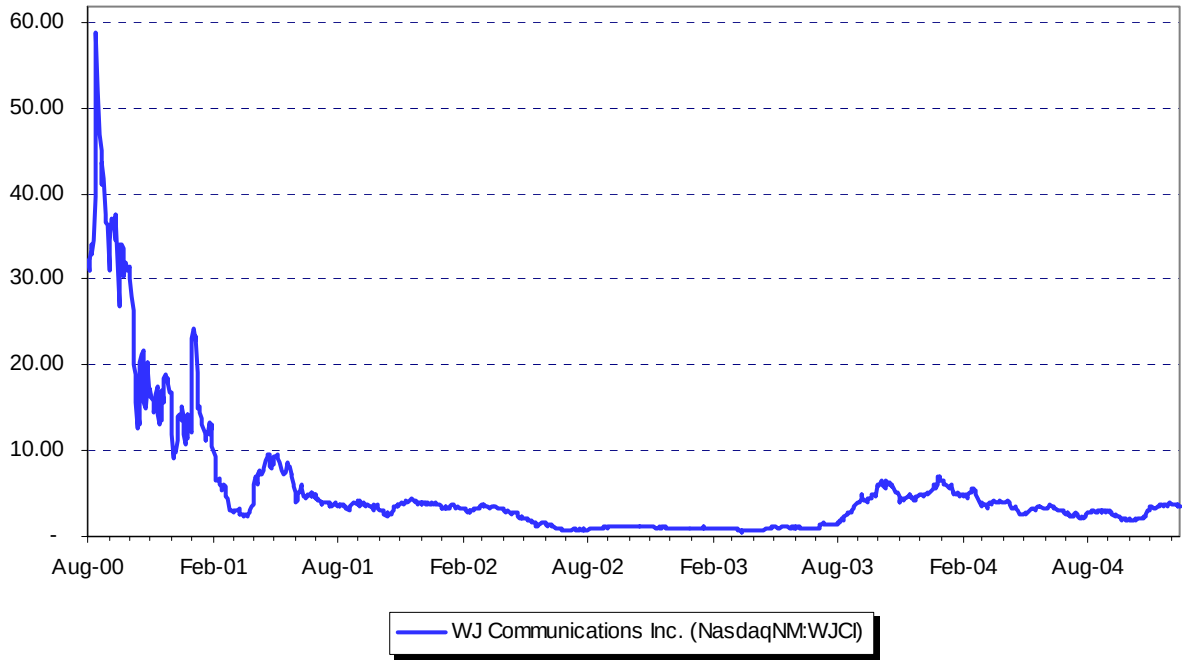
Source: Capital IQ, Glass Lewis.

Chart A26: Enzon Pharmaceuticals - $3.2 Billion Loss in Market Capitalization



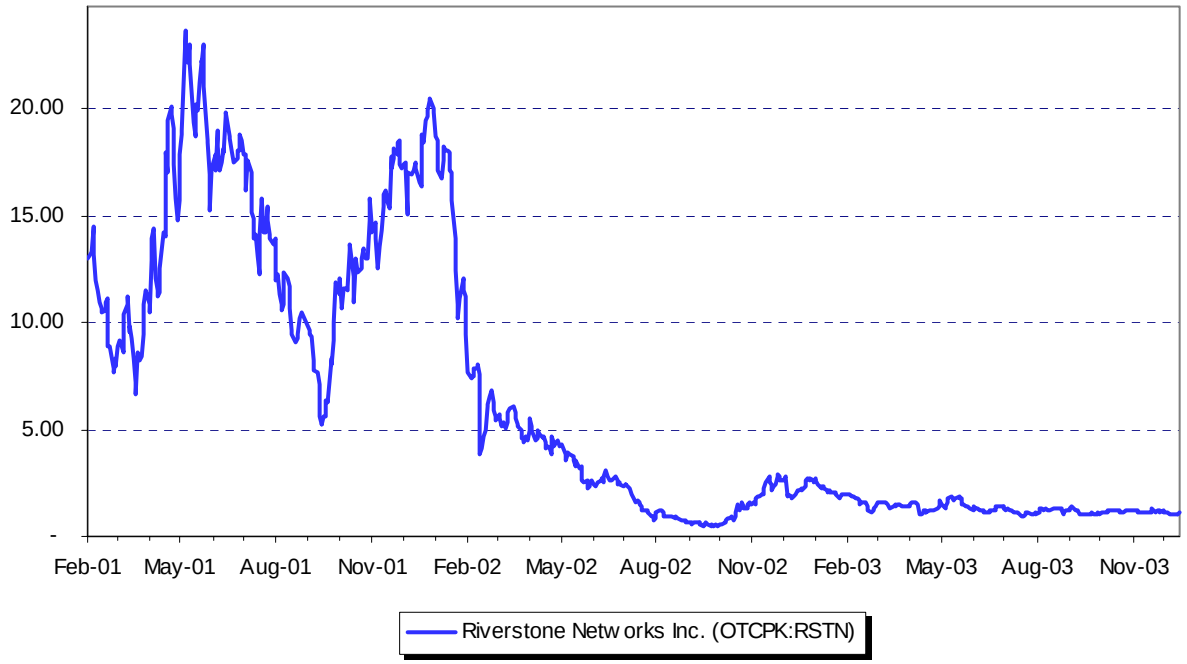
Source: Capital IQ, Glass Lewis. Company announced a restatement on 11/10/2004 and a material weakness existed on 11/15/2004. Company restated results for 2003-2005.

Chart A27: WJ Communications - $2.8 Billion Loss in Market Capitalization



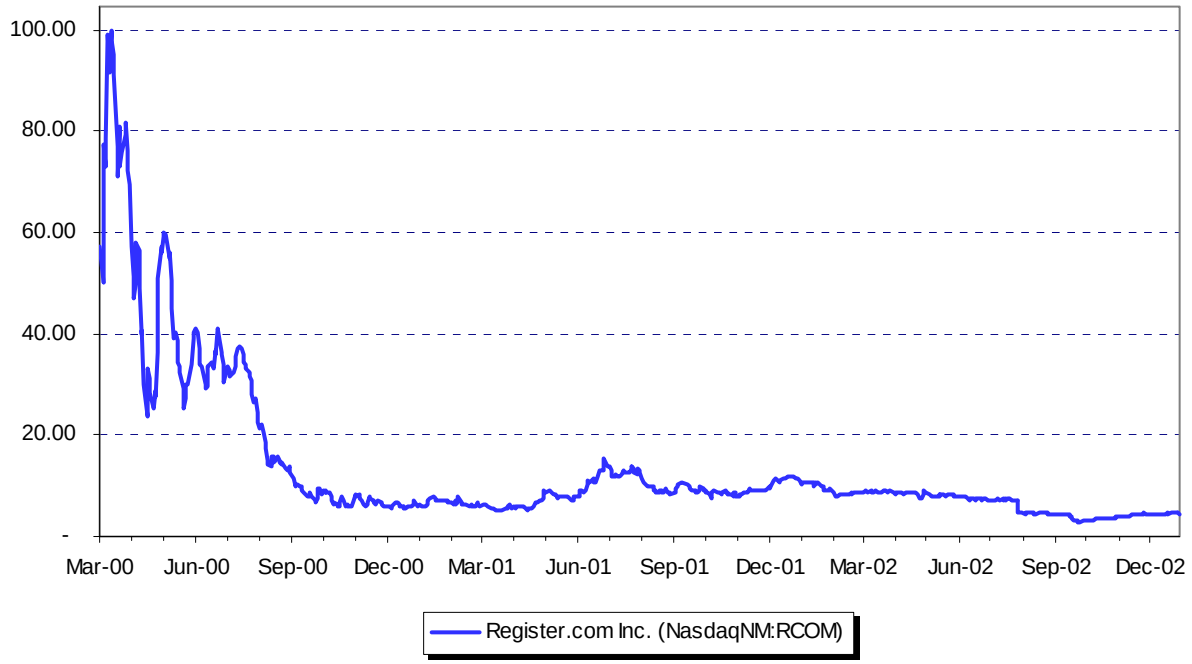
Source: Capital IQ, Glass Lewis. Company announced a material weakness existed on 11/9/2004.

Chart A28: Riverstone Networks - $2.5 Billion Loss in Market Capitalization



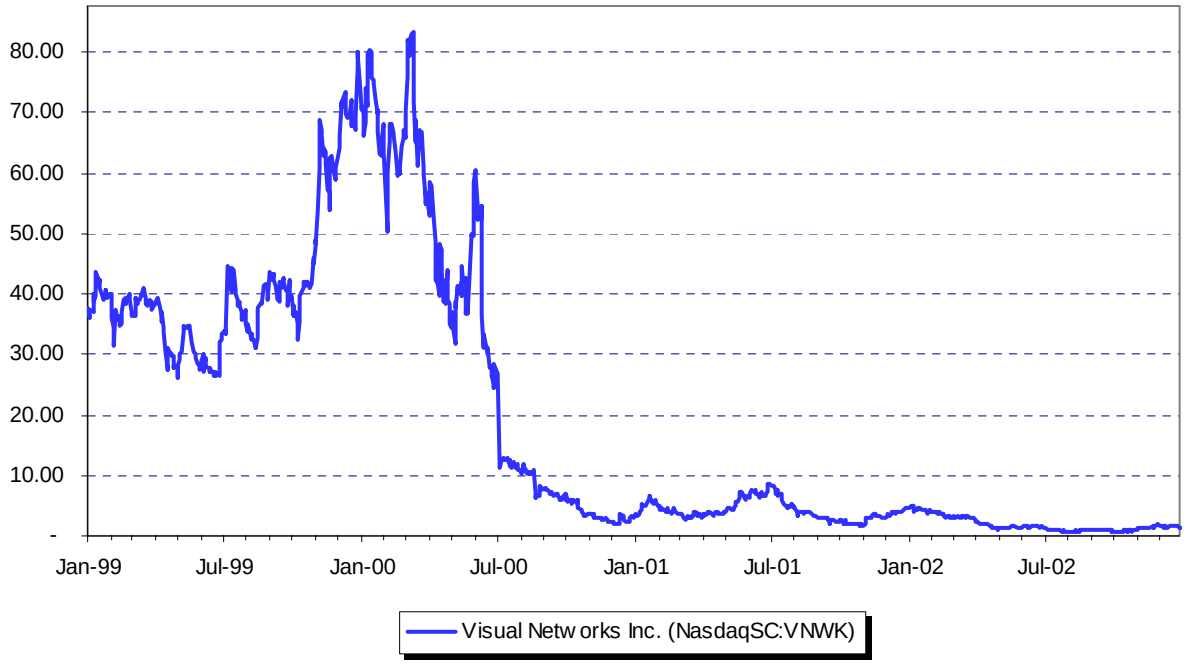
Source: Capital IQ, Glass Lewis. Company announced a restatement and a material weakness existed on 9/2/2004. Company restated results for 2002-2003.

Chart A29: Register.com - $2.1 Billion Loss in Market Capitalization



Source: Capital IQ, Glass Lewis. Company announced a restatement on 11/10/2004 and a material weakness existed on 3/17/2005. Company restated results for 2003-2004.

Chart A30: Visual Networks - $2.1 Billion Loss in Market Capitalization



Source: Capital IQ, Glass Lewis. Company announced a restatement on 3/16/2005. Company restated results for 2002-2003.

Appendix B

INTERNAL CONTROL QUESTIONNAIRE – ICQ
BASIC SYSTEMS

Company Name _____

1. APPROVAL – BASIC SYSTEMS ICQ					
Partner's Initials	20XX	20XX	20XX	20XX	20XX
Reviewed by auditor in charge of engagement					
Approved by audit manager					

2. COMPLETION/UPDATING OF ICQ AND RCW					
Control Objective No.	20XX	20XX	20XX	20XX	20XX
	Completed by	Updated by	Updated by	Updated by	Updated by
Corporate Governance					
1					
Management Control & Monitoring					
2					
Budgeting & Financial Analysis					
3					
Control over Treasury & Tax Functions					
4					
Payment Cycle					
5					
6					
7					
8					
9					
10					
11					
Revenue Cycle					
12					
13					
14					
15					
16					
17					
Inventories					
18					
Controls over MIS					
19					
Financial Reporting & Close Process					
20					

PART 1 – PARTNER'S APPROVAL TO USE BASIC SYSTEMS ICQ

1. This ICQ should only be used after determining the company maintains simple basic systems as opposed to complex computer and financial systems or enters into a significant number of complex and/or unusual transactions for derivatives, revenue recognition, income taxes, etc. Prior approval of the partner in charge of the engagement should be evident annually by initialing and dating the cover sheet in the space provided.

2. The answers to questions ICQ itself may be initially completed by company management. If management or the auditor prepare a flowchart of the flow of the transactions, which is recommended, the appropriate step on the flowchart can be referenced to the applicable ICQ question.

3. The independent auditor is required to test those responses as documented in the Audit Program and Record of Tests (PRT). Where a "No" answer exists it should be documented by the auditor on the record of control weaknesses (RCW) and communicated to the audit committee.

4. Where duties or a supervisory function is described in the question, the name of the responsible person performing, reviewing or supervising the task should be documented in the box.

5. Questions regarding key internal controls, which are necessary to provide reasonable assurance that the account balances in financial statements are materially correct, should be added, or when not applicable, deleted as determined appropriate in the judgment of the independent auditor.

PART 2 – COMPLETION/UPDATING OF ICQ AND RCW

1. The spaces provided should be signed and dated as evidence of the completion/updating of the ICQ and RCW by the member of the staff who has carried out this work. Where consecutive sections have been covered by the same member of the staff, they may be bracketed together with a single signature.

NOTES

Questions dealing with disciplines over basic controls have been marked as follows:

C – Separation of responsibility for custody of assets and the related record-keeping, and physical arrangements that prevent unauthorized access to assets or accounting records (Custodial).

D – Segregation of duties so the work of one person provides a check upon that of another (Division of duties).

S – Supervision of the work of persons involved in the operation of the system of basic controls (Supervision).

Two distinct disciplines over basic controls have been grouped into one (Custodial) for this purpose because the audit response should be the same if either of those disciplines is not present. Questions not marked with a letter deal with basic controls.

Control Objective

An effective Corporate Board ensures oversight and monitoring of tone at the top of the organization, management, key internal controls and the internal and external audit functions through:

- **(a) Appropriate board structure and independence**
- **(b) Oversight of appropriate tone at the top of the organization**
- **(c) Appropriate accountability and monitoring of management**
- **(d) Appropriate oversight and monitoring of financial reporting, internal controls and the auditing functions**

Questionnaire	Flow-chart Ref.	Yes	No	"Yes" Answers PRT Ref.	"No" Answers RCW
Board Structure and Independence 1.1 Does the Board of Directors satisfy the requirements of the SEC and the stock exchanges (example – financial expert on audit committee?)					
1.2 Does the Board of Directors have an independent chairman or a lead director? (D) (S)					
1.3 Do the corporation's directors meet on a regular basis in executive session?					
1.4 Does the Board of Directors have all of the following committees? (a) Nominating and governance (b) Compensation (c) Audit					
1.5 Are all directors on these committees independent?					
1.6 Have the directors demonstrated they have sufficient knowledge, industry experience <u>and</u> time to serve effectively?					
Tone at the Top of Organization 1.7 Does the corporation have a written code of conduct including business ethics?					
1.8 Are the Board of Directors, management and employees required to confirm in writing each year their compliance with the code of conduct?					

Questionnaire	Flow-chart Ref.	Yes	No	"Yes" Answers PRT Ref.	"No" Answers RCW
1.9 Does management appropriately resolve violations of the code of conduct?					
1.10 Does the corporation have a mechanism (hot line) for employees to report inappropriate behavior to an independent party such as the audit committee?					
Appropriate Accountability and Monitoring of Management 1.11 Does the Board of Directors conduct a meaningful performance review of the senior executives including the CEO and CFO? (S)					
1.12 Does the Board regularly receive: (a) key information including financial statements and key performance indicators, (b) significant contracts or commitments being negotiated, (c) major marketing initiatives and new strategies or (d) strategic plans?					
1.13 Does the Board review and discuss with management, at least quarterly, the actual versus budgeted financial results? Are significant budgeted versus actual results adequately documented and explained to the Board of Directors on a timely basis?					
1.14 Does the Compensation Committee or the entire Board establish compensation criteria that avoid pay for inappropriate earnings management?					
Appropriate Oversight and Monitoring of the Financial Reporting and Auditing Functions 1.15 Do the audit committee members have the necessary financial expertise to oversee the financial reporting and auditing process?					
1.16 Does the Board have an audit committee comprised solely of independent members?					
1.17 Do the audit committee members discuss with (i) management, (ii) the external auditor and (iii) to the extent applicable, the internal auditor? (a) Key business operations and processes that affect					

	significant accounting and disclosure requirements? (b) The appropriateness of critical accounting policies? (c) Any changes in accounting policies in the past year? (d) Accounting transactions requiring the use of significant judgments, the accuracy of historical estimates versus actual results, and the reasonableness of estimates made during the current year? (e) Any difficulties encountered by the independent auditors? (f) Any disagreements between management and the auditors? (g) Related party transactions and the appropriate accounting therefore? (h) Any significant changes in accounting processes or procedures? (i) Any large or unusual or non-recurring transactions including for revenue recognition or deferral of expenses?				
1.18	Do the audit committee discussions and questions asked of the internal and independent auditors reflect an independent mindset and reasonable oversight of the financial reporting and auditing functions and processes?				
1.19	Does the audit committee receive, review and discuss with the internal and independent auditors, the scope of their work?				
1.20	Does the audit committee receive and review audit reports of internal audit?				
1.21	Does the head of internal audit report directly to an independent audit committee?				

Control Objective

2. An effective management team is in place that:

(a) Sets an appropriate tone at the top for the company
(b) Ensures that an effective management information system exists that provides
1. necessary and
2. timely information to management
(c) Monitors key internal controls and the financial reporting process on a timely basis
(d) Ensures that effective internal controls exist
(e) Manages change and risk on a proactive basis
(f) Ensures sufficient, competent employees exist in key management and financial reporting positions

Questionnaire	Flow-chart Ref.	Yes	No	"Yes" Answers PRT Ref.	"No" Answers RCW
2.1 Does the corporation have a senior management team that encompasses the necessary key roles, including: (a) CEO (b) CFO or CAO (c) COO					
2.2 Are appropriate job descriptions (including scope of responsibility and duties) for the management team documented?					
2.3 Is the corporation organized to provide for adequate segregation of duties between board oversight, executive management and monitoring, internal checking, and transaction initiation and execution?					
2.4 Has there been significant turnover in key management level positions in the past three years?					
2.5 Is approval authority for transactions such as purchase commitments, large contracts, check signing, etc. approved by the Board and management and formally documented including: (S) (a) Individuals authorized to approve (b) Levels of authority (dollar amounts)					
2.6 Is there adequate evidence approvals are obtained whenever required by the approved policy, without exception or only upon appropriate board approval?					

2.7 Is there a documented process requiring Board approval, for management to deviate from standard corporate policy for the code of ethics, negotiating and entering into contracts, overriding internal controls, purchase authorizations, etc? (S) (D)					
2.8 Have any such deviations been approved and documented by the Board?					
2.9 Does the Company's information systems: (a) capture and provide information necessary for timely and responsive management decision making? (b) timely and accurate accounting and financial reporting data?					
2.10 Does the CEO, CFO and COO prepare, receive and review on a timely basis key financial information, including financial statements and key performance indicators, significant contracts or commitments being negotiated, major marketing initiatives and new strategies or strategic plans?					
2.11 Does management adequately identify, explain and document significant variances in actual versus budgeted financial results on a timely basis?					
Risk Management 2.12 Does management have a process for identifying: (a) Key strategic business risks such as technology advances by competitors, new or developing products, changes in customer, buying patterns, changes in marketing channels and distribution, etc. (b) Risks with respect to significant matters that could affect financial reporting and disclosure, such as judgment regarding slow moving or obsolete inventory, uncollectible accounts receivable, litigation contingencies, etc. (c) Risk of loss mitigation such as insurance coverage, business interruption and disaster recovery, etc. (d) Significant changes occurring in the company, its operations, the industry it operates in that could reasonably be expected to impact amounts reported in the financial statements including the footnotes, as well as SEC filings?					
2.13 Does the company have a process for ensuring the appropriate levels of management including the CEO, CFO and, if applicable, COO, review and approve the					

	financial information included in filings with the SEC?					
2.14	Are such reviews in 2.13 evidenced in writing?					
2.15	Does executive management at least annually identify and document those issues that present the highest risk of fraud, including fraudulent financial reporting?					
2.16	Are such risks reviewed with the audit committee as well as the appropriate preventative controls?					

Control Objective

3. Budgeting and Financial Analysis

A process should exist to analyze the financial results to assess whether there are unexplained or unusual variations in reported amounts or transactions that may require adjustment.

Questionnaire	Flow-chart Ref.	Yes	No	"Yes" Answers PRT Ref.	"No" Answers RCW
3.1 Does the Board of Directors approve an annual budget for: (a) Revenues and expenses? (b) Major cash investments such as purchases of property, plant and equipment? (c) Financing?					
3.2 Are monthly comparisons prepared comparing budgeted and actual operating results including for: (a) Revenues by product line? (b) Major categories of expenses? (c) Expenses by department or functional area? (d) Cash expenditures for investment? (e) Cash balances?					
3.3 Are explanations of variances in budgeted and actual results appropriately documented, explained and, when necessary, appropriate adjusting journal entries made?					
3.4 Are journal entries in (3.3) above reviewed and approved by someone other than the individual responsible for preparing the analysis? (D) (S)					
3.5 Is an analysis of actual financial results compared to those for peer companies prepared by and/or reviewed by someone who does not prepare or approve journal entries used to prepare the financial statements? (D)					
3.6 Do (a) senior management and (b) the Board of Directors receive and review quarterly reports on budgeted versus actual results?					

Control Objective

4. Control over Treasury and Tax Functions are Established to Ensure (See also Sections 10 and 16):

(a) Transactions are properly authorized
(b) Liabilities have been accurately determined

Questionnaire	Flow-chart Ref.	Yes	No	"Yes" Answers PRT Ref.	"No" Answers RCW
Tax Transactions					
4.1 Does the company have an adequate process for identifying and determining all the applicable tax jurisdictions in which tax filings and payments are required to be made?					
4.2 Does the company personnel, or advisors, have the requisite competency for determining the proper balances for income tax accounts recorded in the financial statements?					
4.3 Is there a timely reconciliation performed by company personnel or its advisor of tax liabilities with amounts actually reported and paid to the authorities?					
4.4 Is the calculation of income tax accounts properly reviewed and approved on a timely basis?					
Approval of Transactions					
4.5 Are all new or renewal of lending relationships documented and approved by the Board of Directors?					
4.6 Are account statements from lenders reconciled monthly to the general ledger and are such reconciliations reviewed and approved by a responsible supervisor?					
4.7 Are all settlements with taxing authorities over an established limit approved by management and formally reviewed with the Board?					

Control Objective

5. Control should be established over goods and services received as a basis for:

(a) determining and recording the liability for goods and services received;
(b) where required, posting the items to detailed inventory records.

Questionnaire	Flow-chart Ref.	Yes	No	"Yes" Answers PRT Ref.	"No" Answers RCW
Initial Recording of Receipt of Goods and Services 5.1 Are the following checked by suitable methods (e.g. by counting or weighing and inspecting goods received)and the results recorded at the time of their receipt for subsequent checking with the related invoices: (a) nature, quantity and condition of goods received (including property, plant and equipment and major supplies, e.g. fuel, stationery); (b) major services received (to the extent practicable)?					
5.2 Are the receiving records (5.1) controlled in such a way that it can subsequently be established whether all the related transactions have been accounted for (e.g. by sequentially pre-numbering receiving reports or by entering receipts in a register), in respect of: (a) goods (5.1(a)); (b) major services (5.1(b))?					
Liability for Unprocessed Invoices 5.3 Are there adequate records of goods and services received which have not been matched with the related suppliers' invoices, in respect of: (a) goods (5.1(a)); (b) major services (5.1(b))?					
5.4 Where sequentially pre-numbered forms are used (15.1), are all numbers accounted for as part of the control procedure over unmatched receipts (5.5), in respect of: (a) goods (5.1(a)); (b) major services (5.1(b))?					
5.5 Are unmatched records of goods and services received and reviewed on a regular basis, e.g. monthly, to determine the reasons for any such receipts which have					

	not been matched within a reasonable period of time, in respect of: (a) goods (5.1(a)); (b) major services (5.1(b))?					
5.6	Are the results of the procedures in 5.4 and 5.5 reviewed and approved by a responsible official? (S)					

Control Objective

6. Invoices and related documentation should be properly checked and approved as being valid before being entered as accounts payable.

Questionnaire	Flow-chart Ref.	Yes	No	"Yes" Answers PRT Ref.	"No" Answers RCW
Detailed Checking of Documentation 6.1 Are invoices for goods received checked as to: a) quantities and conditions of goods received (to receiving records); b) nature and quantities of goods ordered (to purchase orders); c) prices and other terms (to purchase orders or suppliers' price lists)?					
6.2 Are invoices for services received compared with the underlying documentation (e.g. records of receipts (5.1), completion reports, leases, records of meter readings or, if such documentation is not available, approved by a responsible official?					
6.3 Are the following functions performed by separate individuals: (a) preparation of purchase orders; (D) (b) preparation of receiving records; (D) (c) checking of purchase invoices (6.1 and 6.2)?(D)					
6.4 Are credit (or debit) memoranda checked to confirm that: (a) they agree with the original records of the goods returned or claims made; (b) where applicable, the prices agree with the original invoice?					
6.5 Are the extensions and additions of invoices and credit (or debit) memoranda adequately checked?					
6.6 Do the invoices and credit (or debit) memoranda bear adequate evidence that the checking (6.1 to 6.5) has been carried out?					

Questionnaire	Flow-chart Ref.	Yes	No	"Yes" Answers PRT Ref.	"No" Answers RCW
Approval of Documentation 6.7 Are invoices and credit (or debit) memoranda subject to final written approval by a responsible official prior to entry as accounts payable?(S)					
6.8 Are adjustments to suppliers' accounts properly documented?					
6.9 Are the adjustments and related documentation (6.8) reviewed and approved by a responsible official prior to entry in the accounts payable records?(S)					

Control Objective

7. Payments in respect of wages and salaries should be:

(a) made only to company employees at authorized rates of pay;
(b) where required, in accordance with records of work performed;
(c) accurately calculated.

Questionnaire	Flow-chart Ref.	Yes	No	"Yes" Answers PRT Ref.	"No" Answers RCW
Standing Payroll Data 7.1 Are the following authorized in writing: a) employees added to payrolls; b) employees removed from payrolls; c) rates of pay and changes in rates of pay; d) payroll deductions other than the compulsory deductions (specify below)?					
7.2 Do persons other than those who prepare the payrolls provide the authorizations required in 7.1? (D)					
7.3 Are there adequate controls designed to ensure that the payroll reflects all authorized standing data (7.1) and only such authorized data?					
Outsourced Payroll 7.4 Are control totals for (a) changes to standing payroll data as well as (b) transaction payroll data provided to a payroll service provider for each payroll reviewed and reconciled on a timely basis to control totals received from the service provider?					
7.5 Does the company: (a) Receive an appropriate SAS 70 report form the service provider? (b) Review the report to determine appropriate controls are effective?					
Transaction Payroll Data 7.6 If employees are paid on the basis of time worked: (a) is the payroll based on adequate time records; (b) where applicable, are the time records checked to supporting records of time spent (e.g. time charges to jobs)					

(c) are the time records (7.4(a)) approved; (d) do the time records (7.4(a)) indicate that overtime has been properly authorized?					
7.7 If employees are paid on the basis of output, are the payments based on output records that are reconciled with production records that are under accounting control?					
7.8 If salaried or other employees not included in 7.4 or 7.5 are paid for overtime, is the payroll based on time records which indicate that overtime has been properly authorized?					
7.9 If employees receive commissions on sales, are the commissions based on sales records that are reconciled with sales (less, where applicable, returns) recorded in the books?					
Payroll Preparation 7.10 Is there a check on the calculation of gross pay (e.g. by agreeing in total with predetermined control totals or with cost records, or by sufficient checking of individual amounts), in respect of: (a) employees paid for time worked (7.4); (b) employees paid for output (7.5); (c) employees paid for overtime (7.6); (d) employees paid commissions (7.7)?					
7.11 Are the calculations and additions of payrolls and payroll summaries checked to an adequate extent?					
7.12 Do payrolls bear adequate evidence that the procedures in 7.8 and 7.9 have been completed?					
7.13 Are payrolls subject to the final written approval of a responsible official before they are paid? (S)					
Payments to Employees 7.14 If employees are paid in cash: (a) is cash withdrawn only for the net amount of the payroll; (C) (b) do persons other than those who prepare the payroll physically control cash until it is distributed to employees; (C) (c) are unclaimed wages promptly recorded and controlled by persons other than those who prepare the payroll? (C)					

Control Objective

8. Payroll deductions should be correctly accounted for and paid to the third parties to whom they are due.

Questionnaire	Flow-chart Ref.	Yes	No	"Yes" Answers PRT Ref.	"No" Answers RCW
Initial Control over Deductions 8.1 Are all payroll deductions recorded in separate control accounts?					
Checking of Amounts To Be Paid to Third Parties 8.2 Are payments of payroll deductions to third parties agreed to the related payrolls?					

Control Objective

9. Reimbursements of imprest and similar funds (e.g. postage and other franking meters, payroll deduction stamps) should be made only for valid transactions.

Questionnaire	Flow-chart Ref.	Yes	No	"Yes" Answers PRT Ref.	"No" Answers RCW
Overall Control of Funds 9.1 Are imprest and similar funds maintained at a reasonable balance in relation to the level of expenditure? (C)					
Expenditures from Funds 9.2 Are all disbursements from imprest and similar funds: (a) supported by adequate documentation; (b) approved where appropriate?					
9.3 In the case of cash funds, are there reasonable limits on: (a) the size of individual disbursements; (C) (b) the extent to which personal checks of employees are cashed; (C) (c) loans and advances (e.g. for wages) made from such funds? (C)					
Requests for Reimbursement of Funds 9.4 Are all reimbursements made on an imprest basis?					
9.5 Are requests for reimbursement accompanied by details of expenditures and supporting vouchers?					
9.6 Are the reimbursements approved by an official who is not the custodian of the funds?(S)					

Control Objective

10. Disbursements from bank accounts should be made for only valid transactions.

Questionnaire	Flow-chart Ref.	Yes	No	"Yes" Answers PRT Ref.	"No" Answers RCW
Preparation of Checks and Bank Transfers 10.1 Are checks and bank transfers prepared by persons other than those who initiate or approve any documents which give rise to disbursements for: (a) payments of accounts payable (control objective 5 and 6 in the Standard ICQ); (D) (b) payrolls and payroll deductions (control objectives 7 and 8); (D) (c) reimbursements of imprest and similar funds (control objective 9)? (D)					
10.2 Are checks and bank transfers prepared only on the basis of evidence that the validity of the transactions has been confirmed in accordance with the company's procedures, in respect of: (a) payments of accounts payable (control objective 5 and 6 in the Standard ICQ); (b) payrolls and payroll deductions (control objectives 7 and 8); (c) reimbursements of imprest and similar funds (control objective 9)?					
10.3 Are checks and bank transfers for transactions which, because of their nature, do not pass through the normal approval procedures as referred to in 9.6, (e.g. purchase of investments, payments of dividends, repayment of debt) initiated only on the basis of proper documentation of the validity of the transactions?					
10.4 Is the documentation in 10.3 reviewed and approved in writing by a responsible official before checks and bank transfers are initiated? (S)					
Signing of Checks 10.5 Are checks signed by officials other than those who approve transactions for payment in respect of: (a) payment of accounts payable (control objective 5 and 6; (C)					

(b) payrolls and payroll deductions (control objectives 7 and 8); (C) (c) reimbursement of imprest and similar funds (control objective 9); (C) (d) other payments (10.3)? (C)					
10.6 At the time of signing checks and bank transfers, does each signatory examine: (a) original supporting documents (e.g. invoices, payrolls, or imprest cash records) which have been checked and approved in accordance with the company's procedures (control objectives 5, 6, 7, 8 and 9 and Question 10.3); (S) or (b) substitute documents (such as remittance advices or check requisitions) which provide adequate evidence of the validity of the related transactions? (S)					
10.7 Are the supporting documents effectively cancelled by, or under the control of, the signatories to prevent subsequent re-use? (C)					
10.8 If a mechanical check signer is in use, is there adequate control over the custody and use of the signer and the signature plates? (C)					
Control of Checks and Bank Transfer after Signing 10.9 After signing, are checks and bank transfers forwarded directly to the payees (or to the bank with the bank transfer lists) without being returned to the originators or others who are in a position to introduce documents into the cash disbursements system? (C)					

Control Objective

11. General ledger entries arising from the payments cycle should be accurately determined.

Questionnaire	Flow-chart Ref.	Yes	No	"Yes" Answers PRT Ref.	"No" Answers RCW
Classification of Expenditures					
11.1 Is the coding of the following transactions for posting to general ledger accounts checked to an appropriate extent: (a) invoices and other supporting documentation related to the payment of accounts payable; (b) payrolls; (c) reimbursements of imprest and similar funds; (d) disbursements from bank accounts not covered in (a) to (c) above; (e) depreciation of property, plant and equipment?					

Control Objective

12. Control should be established over goods shipped and services performed as a basis for:

(a) making charges to customers for all such sales;
(b) determining the amount of the related revenues which have not been entered as accounts receivable;
(c) where required, making the related entries in the detailed inventory records.

(This control objective is not intended to cover sales in retail and similar businesses where the invoices or similar documents are issued to customers at the time the goods are supplied (see control objective 13.)

Questionnaire	Flow-chart Ref.	Yes	No	"Yes" Answers PRT Ref.	"No" Answers RCW
Initial Recording of Goods Shipped and Services Performed 12.1 Are the following recorded for accounting control purposes at the time the goods are shipped or the services performed; (a) quantities and description of all goods shipped; (b) all services performed for customers?					
12.2 Are the records (12.1) controlled in such a way that it can subsequently be established whether all the related transactions have been accounted for (e.g. by sequentially pre-numbering delivery slips or by entering deliveries in a register), in respect of: (a) goods (12.1(a)); (b) services (12.1(b))?					
Unmatched Records 12.3 Where sequentially pre-numbered forms are used (12.1), are all numbers accounted for as part of the procedure for ascertaining unmatched items in respect of: (a) goods (12.1(a)); (b) services (12.1(b))?					
12.4 Are records maintained of goods shipped and services performed that have not been matched with the related sales invoices, in respect of: (a) goods (12.1(a)); (b) services (12.1(b))?					

12.5 Are unmatched records of goods shipped and services performed (12.4) reviewed on a regular basis (e.g. monthly) to determine the reasons for any such items which have not been matched within a reasonable period of time, in respect of: (a) goods (12.1(a)); (b) services (12.1(b))?					
12.6 Are the results of the procedure in 12.5 reviewed and approved by a responsible official? (S)					

Control Objective

13. Control should be established over cash sales of goods and services as a basis for:

(a) accounting for all such sales;
(b) where required, making the related entries in the detailed inventory records.

(For this purpose "cash sales" should be regarded as including credit sales made under similar conditions, i.e. where the customer receives the goods or services on the vendor's premises and the sales invoice or similar document is issued to the customer at the same time.)

Questionnaire	Flow-chart Ref.	Yes	No	"Yes" Answers PRT Ref.	"No" Answers RCW
Initial Recording of Cash Sales 13.1 Is each cash sales recorded for accounting control purposes at the time it is made?					
13.2 Are the records (13.1) controlled in such a way that it can subsequently be established whether all the related transactions have been accounted for (e.g. by sequentially pre-numbering or the use of cash register tapes)?					
13.3 Where sequentially pre-numbered forms are used (13.2) are there adequate controls for: (a) accounting for the usage of documents issued (e.g. by recording issues to specific persons in a register and accounting for their use); (b) dealing with cancelled and spoiled documents?					
13.4 Are cash and checks received and credit sale documents reconciled or checked in total each day with the records (13.1) by persons other than those making the sales? (D)					
13.5 Are the totals of cash and checks received and credit sales documents recorded at the time the reconciliations (13.4) are carried out?					
13.6 Are the results of the procedures in 13.3, 13.4 and 13.5 reviewed and approved by a responsible official? (S)					

Control Objective

14. All charges and credits should be appropriately checked as being valid before being entered in the accounts receivable records.

Questionnaire	Flow-chart Ref.	Yes	No	"Yes" Answers PRT Ref.	"No" Answers RCW
Detailed Preparation and Checking of Documentation 14.1 Are sales invoices: (a) prepared from the actual records of goods shipped or services performed (12.1)?					
14.2 Are invoiced prices: (a) determined from approved sales orders or price lists which are properly authorized and regularly updated?					
14.3 Are credit memoranda: (a) prepared from the actual records of goods returned or claims made?					
Approval of Documentation 14.4 Are the following sales invoices subject to final approval by a responsible official before they are issued and prior to entry as accounts receivable: (a) invoices subject to special terms and discounts (including "no charge" invoices); (S) (b) other invoices where such approval is desirable (e.g. in respect of invoices of a substantial value)? (S)					

Questionnaire	Flow-chart Ref.	Yes	No	"Yes" Answers PRT Ref.	"No" Answers RCW
14.5 Are all credit memoranda subject to final approval by a responsible official before they are issued and prior to entry in the accounts receivable records? (S)					
14.6 Are all other adjustments to customers' accounts properly documented and authorized by a responsible official prior to entry in the accounts receivable records? (S)					

Control Objective

15. All valid accounts receivable transactions, and only those transactions, should be accurately recorded as accounts receivable.

Questionnaire	Flow-chart Ref.	Yes	No	"Yes" Answers PRT Ref.	"No" Answers RCW
Accounting for All Transactions 15.1 Is the system such (e.g. by sequential pre-numbering or the use of invoice registers) that all of the following documentation is accounted for and the amounts posted to the accounts receivable control accounts. (a) Sales invoices (14.1); (b) Credit memoranda (14.3); (c) Other adjustments to customers' accounts (14.6)?					
15.2 Are those who account for sales invoices, credit memoranda and other adjustments to customers' accounts, persons other than those who: (a) record shipments; (C) (b) record goods returned and claims made by customers; (C) (c) deal with cash receipts functions? (C)					
15.3 Is a review made on a regular basis (e.g. monthly) to determine the reasons for any documents which have not been accounted for (15.1) within a reasonable period of time?					
15.4 Are the results of the procedures in 15.3 reviewed and approved by a responsible official? (S)					

Control Objective

16. Control should be established over all cash and checks received and they should be deposited promptly in the company's bank accounts.

Questionnaire	Flow-chart Ref.	Yes	No	"Yes" Answers PRT Ref.	"No" Answers RCW
Control over Remittance Received by Mail 16.1 Are the records prepared in detail of cash and checks received when the mail is opened?					
16.2 Are these records (16.1) prepared by persons other than those who deal with? (a) accounts receivable; (C) (b) accounts payable; (C) (c) the general ledger? (C)					
16.3 Is the mail opening and recording of receipts reviewed by a responsible official? (S)					
16.4 Are checks and similar documents marked or endorsed at the point of receipt to prevent their being deposited into bank accounts other than those of the company? (C)					
Control of Cash Sales 16.5 Is there adequate physical control over cash received? (C)					
Frequency of Banking 16.6 Are the following deposited intact daily: (a) Remittances received by mail; (C) (b) Cash sales? (C)					

Control Objective

17. General ledger entries arising from the revenue cycle should be accurately determined.

Questionnaire	Flow-chart Ref.	Yes	No	"Yes" Answers PRT Ref.	"No" Answers RCW
Analysis of Revenue					
17.1 Is the coding of the following transactions for posting to general ledger accounts checked to an appropriate extent: (a) sales invoices; (b) credit memoranda; (c) other adjustments to customers' accounts; (d) documents that support the entry for cost of sales; (e) cash and checks received?					

Control Objective

18. Adequate procedures should be followed to confirm the physical existence of inventories recorded in the general ledger.

(Where the physical existence of inventories is determined other than on a continuous basis, the tests of the answers to the details questions set out below will normally be carried out as part of the validation tests. As a result, no separate PRT need normally be prepared in these circumstances.)

Questionnaire	Flow-chart Ref.	Yes	No	"Yes" Answers PRT Ref.	"No" Answers RCW
Quantities 18.1 Is the physical verification of inventories carried out by persons other than those who: (a) have physical custody of inventories? (C) (b) maintain the related control account? (D)					
18.2 Is the physical verification of inventories (18.1) carried out under the supervision of a responsible official? (S)					
18.3 Are adequate written instructions covering all phases of the count procedures, including the matters dealt with in 18.5 to 18.16 below, given to persons participating in the count?					
18.4 Are the written instructions (18.3) reviewed and approved by a responsible official before being issued? (S)					
18.5 Is the stock to be counted arranged in such a way that an accurate count can be obtained?					
18.6 Are items of stock not to be included in the count (e.g. stock owned by third parties, scrap and obsolete and damaged goods which have been written off) adequately segregated from other stock?					
18.7 Is the stock marked, labeled or otherwise described in such a way that accurate identification can be made by persons counting the stock?					
18.8 Are the methods used to determine quantities (e.g. counting, weighing, etc.) adequate to obtain accurate determination of quantities?					

Questionnaire	Flow-chart Ref.	Yes	No	"Yes" Answers PRT Ref.	"No" Answers RCW
18.9 Are there adequate procedures for determining quantities of goods which are not susceptible to direct physical counting (e.g. some types of work in progress)?					
18.10 Are count totals checked to an adequate extent by persons other than the original counters? (D)					
18.11 Are there adequate procedures to ensure that all stock is included in the count and that no items are included twice (e.g. by marking stock which has been counted, leaving count tags attached to stock and/or working with a count plan for each area)?					
18.12 Do persons supervising the count: (a) make test counts in all areas; (S) (b) review all areas where stock is kept to ensure that all stock has been counted and the counts recorded? (S)					
18.13 Are the arrangements such that it can be ascertained subsequently that all count records have been accounted for (e.g. by using pre-numbered count tags and recording the numbers used)?					
18.14 Are adequate arrangements made (e.g. by forbidding movements during the count) to ensure that stock is not missed or double-counted in respect of: (a) incoming goods; (b) outgoing shipments; (c) internal stock movements?					
18.15 Are arrangements made so that it can subsequently be established that all stock included in the count is reflected in the relevant general ledger balance and the detailed inventory records at the count date and that stock movements subsequent to the count are not so included (e.g. by listing accounting documentation relating to stock movements in the period immediately preceding and following the count or by recording cut-off numbers of pre-numbered documents)?					
18.16 Are there adequate procedures, including accounting and physical control over movements during the count period, for verifying the quantities of stock in the hands of third parties (e.g. by confirmation or, where significant, by counting)?					

Summarization 18.17 Are inventory quantities priced, extended and summarized by persons other than those who: (a) have physical custody of stock; (C) (b) maintain the related control accounts? (D)					
18.18 Are all count documents accounted for as part of the summarization procedures (e.g. by accounting for the sequences of numbers of pre-numbered lags used)?					
18.19 Are costs used in summarizing physical counts determined by reference to an appropriate source?					
18.20 Inventory summaries checked to an adequate extent in respect of: (a) quantities, including, where required, conversions of count units to pricing units (e.g. united into dozens or pounds into tons); (b) prices uses; (c) arithmetical accuracy?					
18.21 Are there adequate procedures for ensuring that accounting documentation originating in the count period (18.15) is reflected in the control account and detailed inventory records in the proper accounting period?					
18.22 Are significant differences between inventory amounts as determined by physical count and the balances in inventory control accounts investigated?					

Control Objective

19. Controls over Management Information Systems (MIS)

Controls should be established to prevent inappropriate or unauthorized usage of company systems. The company should also have acceptable redundancy and disaster recovery plans in place

Questionnaire	Flow-chart Ref.	Yes	No	"Yes" Answers PRT Ref.	"No" Answers RCW
Controls should be established to ensure appropriate access to company systems.					
19.1 Does the administrator occasionally scan audit logs of system access to identify unusual system activity (e.g. programs, time of day, etc.)?					
19.2 Does a responsible supervisor specify system access privileges for each new employee? (S)					
19.3 Are changes in system access for an employee approved and documented by a responsible official (D) (S)?					
19.4 Are external contractors provided user access and if so, is their access appropriately approved and terminated??					
19.5 Is system access for terminated employees removed in a timely manner?					
19.6 Are critical systems securely restricted?					
19.7 Do users inappropriately share accounts or passwords with anyone else?					
19.8 Are users required to change passwords periodically and use robust passwords?					
19.9 Are there any automated system and application alerts which notify appropriate parties when abnormal activity is detected?					
19.10 Is there a listing of all company systems which specifies who has access to which company system?					

19.11 Is there an appropriate level of segregation of duties in regard to company systems?					
19.12 Are there appropriate procedures and safeguards in place when a terminated administrator leaves?					
19.13 Are all system administrator functions password protected?					
19.14 Does the system administrator have complete access to all systems including critical systems?					
19.15 Does someone other than the administrator occasionally scan the administrator audit logs, if available?					
Policies should be established to ensure only approved software is installed. 19.16 Are users able to install software on their computers?					
19.17 Are users restricted as to which software can be installed on their computers?					
19.18 Are users able to download software from the internet?					
19.19 Is there any internally developed software in use? (a) Is tested and approved prior to placement into production?					
19.20 Are the testing and implementation controls effective for internally developed software?					
Controls should be in place to ensure the proper use of company hardware and software. 19.21 Are there adequate policies regarding the personal use of the computer?					
19.22 Can a user take company information out of the office either on a laptop or on recordable media without proper approvals?					
19.23 If sensitive date is taken off site, are there adequate controls in place to ensure confidential records such as payroll or HR records are not lost or stolen?					

19.24 Is there an inventory maintained and updated timely of all hardware and software?					
19.25 Are there procedures in place to ensure proper payment for all software licensing?					
Controls should be in place and evaluated for any utilized third party service. 19.26 Does the company utilize an external service for processing payroll or other critical applications?					
19.27 Have the internal controls for the external service been reviewed and determined to be adequate?					
Controls should be established to ensure data is not lost or compromised by external sources. 19.28 Does the company use adequate firewall for its network?					
19.29 Does the company communicate across the internet between offices?					
19.30 Are proper controls in place to ensure secure communication?					
19.31 Does the company use adequate antivirus software?					
19.32 Are updates to antivirus software automatically installed on users' computers?					
19.33 Does the company allow dial-up or other remote connections such as VPN?					
19.34 Are controls in place to ensure secure communication from remote connections?					
The company should have acceptable redundancy and disaster recovery plans in place. 19.35 Are backups created on a regular basis?					
19.36 Are the backups adequately protected?					
19.37 Are backups physically stored at a remote site?					

19.38 Are backups verified for completeness?					
19.39 Does the company have a disaster recovery plan in place?					

Control Objective

20. Financial Reporting and Close Process

Controls should be established over financial reporting, including the close process to assure completeness, accuracy and compliance with GAAP.

Control should be established over general ledger maintenance: 20.1 Are changes to the chart of accounts : (a) documented (b) processed timely (c) approved by a responsible supervisor? (S)					
Control should be established over postings from the sub-ledger to the general ledger: 20.2 Are postings from sub-ledger to GL made completely, accurately and in the proper period?					
20.3 Is suspense, invalid or other rejected or improper automated postings analyzed and resolved on a timely basis?					
20.4 Are unauthorized posting to the General Ledger prevented and detected?					
Control should be established over recording journal entries: 20.5 Are journal entries recorded completely and accurately?					
20.6 Are non-recurring journal entries: (a) complete and accurate (b) processed timely and (c) approved by a responsible supervisor? (S)					
Control should be established over closing journal entries: 20.7 Are period-end closing adjustments recorded completely and accurately?					
20.8 Are closing procedures consistent across all business units and departments?					

20.9 Are closing adjustments approved by a responsible supervisor?					
20.10 Does a process exist to identify all non-standard, closing adjustments and are they reviewed and approved by an appropriate level of management?					
20.11 Does a process exist to ensure all of all “top side” journal entries recorded after an initial close and “flash” report is generated are identified and reviewed by a responsible official.					
Control should be established over accounting policies and GAAP: 20.12 Are accounting policies documented and kept current in response to changes in the company’s business and operations?					
20.13 Are all transactions accounted for consistently with established accounting policies?					
20.14 Are accounting policies kept current in response to changes in GAAP?					
20.15 Are changes in accounting reviewed and approved by the: (a) CFO (b) CAO (c) Audit Committee					

COMMENTS FOR BASIC SYSTEMS

Certain questions that might otherwise appear in a standard ICQ have been omitted from the Basic Systems ICQ. Some standard ICQ questions relating to basic controls and most standard ICQ questions relating to segregation of duties have been omitted on the assumption that such controls do not normally exist in companies for which the Basic Systems ICQ is appropriate.

The comments below explain why certain questions would be omitted from the control objectives included in the Basis System ICQ. It is anticipated that this section may be of some use to the auditor in determining whether it is appropriate to apply the Basic Systems ICQ.

CONTROL OBJECTIVE	COMMENTS FOR BASIC SYSTEMS
5	Although part (a) of this control objective is relevant to the audit of companies with Basis Systems, such companies typically do not have the appropriate divisions of duties in respect of controls over completeness of unmatched records of goods and services received. Also, systematic procedures for determining the liability for major services received other than those checked by the procedures in 2.1(b) are typically not found in such companies. Accordingly, related questions have been omitted. In addition, detailed records are typically not maintained and accordingly, the related question has been omitted.
7	Although this control objective is relevant to the audit of companies with Basic Systems, the use of predetermined control totals and the checking of payroll calculations and checks by persons other than those who prepare the payroll are typically not found in such companies. Accordingly, related questions have been omitted.
8	Although this control objective is relevant to the audit of companies with Basic Systems, the payments of payroll deductions to third parties are typically agreed to the related payrolls in such companies by the person who prepared the payroll. Accordingly, the related question has been omitted.
9	Although this control objective is relevant to the audit of companies with Basic Systems, it is typical in such companies that the same person has custody of, or access to, both imprest and non-imprest funds and there is usually no periodic verification of such funds by persons other than the custodian. Accordingly, related questions have been omitted.
10	Although this control objective is relevant to the audit of companies with Basic Systems, it is typical in such companies that: (a) there are no controls over the custody and usage of checks; (b) there is no comparison of the details of disbursements as shown by the disbursement records with those of payments made through the bank accounts by persons other than those who prepare such records.

CONTROL OBJECTIVE	COMMENTS FOR BASIC SYSTEMS
11	Although this control objective is relevant to the audit of companies with Basic Systems, the controls over the approval of coding and arithmetic accuracy of summaries used for making the general ledger entries are typically not found in such companies.
12	Although parts (a) and (b) of this control objective are relevant to the audit of companies with Basic Systems, typically in such companies the persons making the shipments generally record them and also have access to inventories; also the review of unmatched records of goods shipped and services performed is generally made by the persons maintaining such records. Accordingly, the related questions have been omitted. In addition, detailed inventory records are not typically maintained and accordingly the related question has been omitted for an audit of these companies.
13	Typically detailed inventory records are not maintained by such companies and accordingly, the related question has been omitted.
14	In companies with Basic Systems the extent of the checking contemplated typically does not include division of duties. Accordingly, certain questions have been omitted related to these types of controls.
15	Although this control objective is relevant to the audit of companies with Basic Systems, the appropriate divisions of duties in respect of completeness controls and maintenance of control accounts and detailed records and agreement of detailed records with customers' records are typically not found in such companies. Accordingly, questions related to this function that might otherwise be asked, have been omitted.
16	Although this control objective is relevant to the audit of companies with Basic Systems, the comparison of the record of receipts with bank statements and receipted deposit slips is not typically found in such companies. Accordingly, the related questions have been omitted.
17	Although this control objective is relevant to the audit of companies with Basic Systems, the controls over the approval of coding and arithmetic accuracy of summaries used for making the general ledger entries are typically not found in such companies. Accordingly, the related questions have been omitted.
18	Although this control objective is relevant to the audit of companies with Basic Systems, such companies typically do not maintain detailed inventory records or make use of cycle counts; also, differences between the physical count and the balances in the inventory control account are frequently investigated by those who maintain the control account or who have physical custody of the stocks. Accordingly, the related questions have been omitted.

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GLASS LEWIS & Co.

CONTROL DEFICIENCIES
TREND ALERT

Control Deficiencies – Finding Financial Impurities

Analysis of the 2004 and Early 2005 Deficiency Disclosures

Accurate, reliable financial information is as vital to efficient capital markets as water is to the human body. We trust the accuracy of financials as we do the safety of our drinking water – a faith that can make detection of problems difficult. Just as contaminants may not be visible in a glass of water, neither do they readily appear in a set of financial statements. We rely on quality control systems to keep us personally and financially safe. For transparent financial statements and disclosures, those procedures must include effective internal controls.

The sheer volume of internal control deficiencies disclosed by public companies in 2004 and the first four months of 2005 indicates the waters of financial information are murky. Ineffective controls lead to undetected errors. Contaminated financial data, in turn, lead to poor investment decisions harmful to investors' well-being. Fortunately, Section 404 of the Sarbanes-Oxley Act of 2002 helps scrub financial information produced by companies with inadequate or nonexistent internal processes. Cleaner information reflects economic reality more truly, allowing for investors to make higher quality decisions.

Key Findings

- The number of companies disclosing material weaknesses (the most severe type of control problem) increased 87% (to 586 companies) in just the first four months of 2005 over the entire year of 2004 (313 companies).
- Only 43% of companies that received a qualified opinion on internal controls effectiveness had previously cautioned investors that deficiencies existed and 94% had certified their internal controls as effective as recently as the quarterly filing before the annual report was issued with a qualified opinion.
- Control deficiency disclosures increased 39%, from 462 companies in 2004 to 642 in 2005 through May 2.
- The number of calendar year-end companies reporting material weaknesses rose from 199 in 2004 to 453 in 2005, a 128% increase.
- As of May 2, 2005, auditors issued qualified opinions for 366 companies on their Section 404 reports, including 351 adverse opinions and 15 disclaimed opinions.
- Nearly 11% of public companies with market capitalizations greater than $75M disclosed control deficiencies between Jan. 1, 2004, and May 2, 2005.
- The most common types of material weakness reported were financial systems & procedures, and personnel issues, representing about 60% of disclosures between Jan. 1, 2004 and May 2, 2005, the compliance deadline.
- Since January 2004, 8% of public companies audited by Deloitte & Touche and KPMG reported material weaknesses and 4% received qualified opinions. In comparison, 6% of public companies audited by PwC and Ernst & Young disclosed material weaknesses and 3% received qualified opinions. Among the Tier 2 audit firms, 15% of public companies audited by Grant Thornton and BDO Seidman disclosed material weaknesses and 5% received qualified opinions.
- The stock price of companies reporting a material weakness between Jan. 1, 2004, and May 2, 2005, declined 0.9% more than the market seven days after announcing the deficiencies. The stock price of companies that filed late Section 404 reports dropped a relative 2.9% seven days after announcing control deficiencies.
- Management who failed to comply with federal laws by allowing material weaknesses have often not been held accountable. Executive compensation, including bonuses and equity awards, continues to increase in many of these instances.

Important disclosure information at end of report.

We believe strong, effective controls form the foundation for accurate, timely financial information for use by investors, regulators, and internal users. While few argue against this belief, many bemoan the cost of compliance with SOX 404 (Section 404 of the Sarbanes-Oxley Act of 2002).

Rules calling for effective internal controls are not new. Since 1977, with the enactment of the Foreign Corrupt Practices Act, companies have been required to have effective controls. SOX 404 merely requires that an independent auditor attest to these controls.

Before a backlash against the new rules prompts an overhaul to Sarbanes-Oxley, investors and policymakers should evaluate the outcome from the first year of compliance. Our report describes the extent of control deficiencies and how they muddy the financial statements of public companies. Specifically, we examine the 2004 and 2005 control deficiency disclosures in six ways: 1) Description of deficiency; 2) Section 404 opinion; 3) Market reaction as measured by stock price impact; 4) Executive compensation despite deficiencies; 5) Auditor role; and 6) Company size as measured by market capitalization.

Deficiency disclosures increased as deadline approached

Increased scrutiny by independent auditors persuaded more companies to admit to potential internal control problems as the May 2, 2005, compliance deadline neared. In 2004, 462 companies disclosed internal control deficiencies.[1] Through the first four months of 2005, another 642 companies reported various types of internal control deficiencies (including material weaknesses, significant deficiencies, and other control deficiencies).

SOX 404 requires public companies with fiscal year-ends after Nov. 15, 2004, to have their independent auditor attest to the effectiveness of internal controls. It is troubling that as the deadline neared the number of reported control deficiencies rose significantly even though many CEOs and CFOs had reported earlier – under the requirements of Section 302 certifications – that their internal controls were effective.[2] Of the 1,104 companies that disclosed deficiencies between Jan. 1, 2004, and May 2, 2005, 81%, concluded the deficiencies rose to the level of a material weakness.

The SOX 404 requirements were effective for the first annual period ending after Nov. 15, 2004, for companies that are accelerated filers with the SEC.[3] Guidelines from the SEC and the Public Company Accounting Oversight Board (PCAOB) required companies with Dec. 31 fiscal year-ends to include in their 2004 annual Form 10-K an auditor's report on management's assessment of internal controls as well as the effectiveness of internal controls. The filing deadline was March 16, but extensions were available. By filing Form 12b-25, 189 companies received a 15-day extension for their Form 10-K and auditor's reports. Companies with market capitalizations of $700M or less qualified for a 45-day extension, to May 2. At the time of this report, 112 companies took advantage of the 45-day extension. With the first round of SOX 404 compliance filings now complete, we chose the May 2 milestone as our cut-off point to evaluate the nature and impact of the control deficiency disclosures reported in the 16-month period from January 2004 through April 2005.

The Sarbanes-Oxley Act was passed in July 2002. Companies have had more than 2 ½ years to get their internal controls in order.

[1] The number of disclosures made in 2004 is based on *Compliance Week*, which reported 582 internal control disclosures for 2004. After eliminating duplicate disclosures, control deficiencies previously announced in 2003, and disclosures of alleged deficiencies in class action lawsuits (i.e., third-party allegations not confirmed by the company), we identified 462 companies that first announced control deficiencies between Jan. 1 and Dec. 31, 2004.

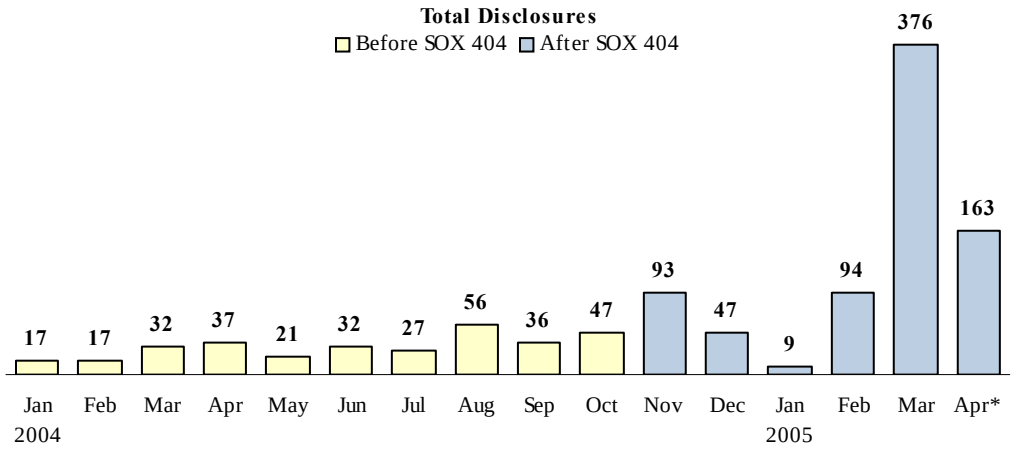
[2] Section 302 of the Sarbanes-Oxley Act requires the principal executive and financial officers to make quarterly and annual certifications with respect to internal controls. Section 302 became effective on Aug. 29, 2002.

[3] Accelerated filers include companies with market capitalization of $75M or more that have been subject to SEC reporting requirements for at least 12 months, have filed at least one annual report and are not eligible to use small-business (SB) forms. There are approximately 6,000 companies in the FactSet database with $75M or more in market capitalization.

Number of control deficiencies reported

Chart 1 shows the number of filings announcing an internal control deficiency (includes material weaknesses, significant deficiencies, and other control deficiencies) since the beginning of 2004. Control deficiency disclosures began to ramp up in November 2004 as many calendar year-end companies, in preparation for SOX 404 compliance, used their third-quarter reports to announce ineffective internal controls. In March 2005, with the annual report deadline approaching for calendar year-end companies, the number of control deficiency disclosures exploded to 376. The chart designates the Nov. 15, 2004 effective date of compliance with SOX 404.

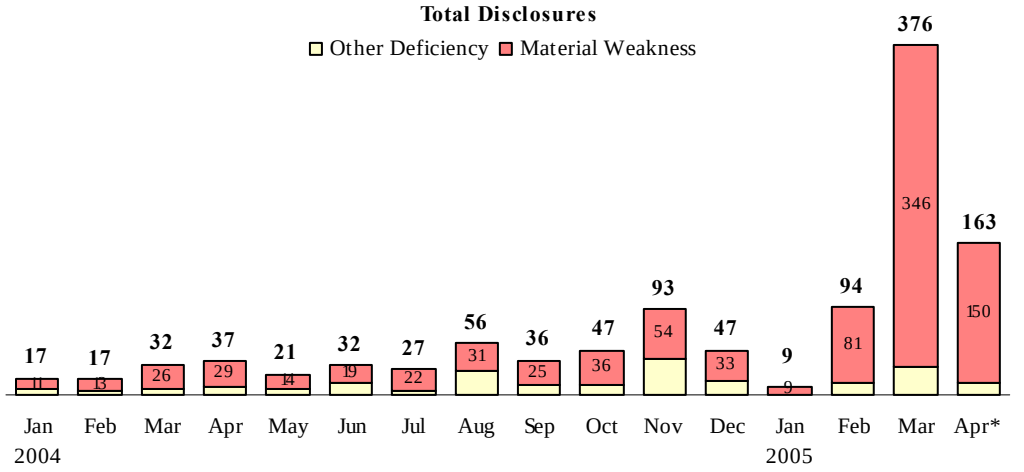
Chart 1: Internal Control Deficiency Disclosures for January 2004 through April 2005: 1,104



Source: Glass Lewis, Company Filings. * April 2005 includes disclosures from 4/1/2005 through 5/2/2005.

Material weaknesses, the most severe of control deficiencies, dominated the types of disclosures. After 313 companies reported material weaknesses in internal controls in 2004, another 586 disclosed material weaknesses in the first four months of 2005. Chart 2 shows the 899 disclosures of material weaknesses in internal controls.

Chart 2: Internal Control Deficiency Disclosures for January 2004 through April 2005: 1,104



Source: Glass Lewis, Company Filings. * April 2005 includes disclosures from 4/1/2005 through 5/2/2005.

Table 1 shows a summary of the number of companies disclosing control deficiencies between January 2004 and May 2, 2005. There are three types of deficiencies in internal controls: material weaknesses, significant deficiencies, and other

control deficiencies. Material weaknesses are the most severe because they result in a higher likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected.[4]

Table 1: Control Deficiencies by the Numbers

	Total
Companies Disclosing Internal Control Deficiencies	1,104
Companies Disclosing Material Weaknesses	899
Companies Receiving Qualified Audit Opinions	366

Source: Glass Lewis, Company Filings.
Total: Disclosures from January 1, 2004, through May 2, 2005.

Type of control deficiencies disclosed

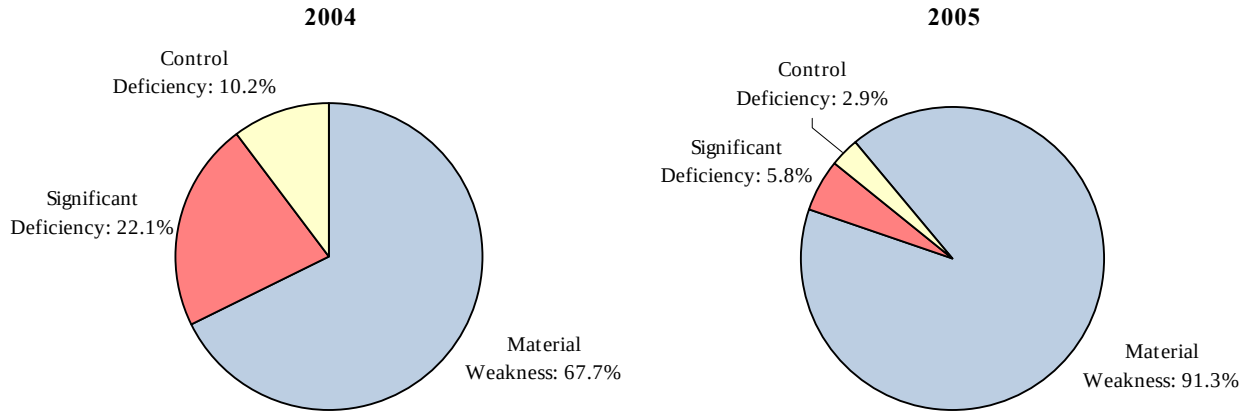
Between January 2004 and the May 2, 2005, SEC deadline for calendar year-end companies, 899 companies disclosed material weaknesses in internal controls. Table 2 and Chart 3 show the breakdown of the reported deficiencies.

Table 2: Number of Control Deficiency Disclosures by Type

Deficiency Type	2004	2005	Total
Material Weakness	313	586	899
Significant Deficiency	102	37	139
Other Control Deficiency	47	19	66
Total	462	642	1,104

Source: Glass Lewis, Company Filings. Note: Disclosures from January 1, 2004 through May 2, 2005.

Chart 3: Proportion of Control Deficiency Disclosures by Type



Source: Glass Lewis, Company Filings. Note: 2005 includes disclosures through May 2, 2005.

The number of material weakness disclosures in just the first four months of 2005 increased 87% over the number disclosed during all of 2004. In the past companies seemed quick to classify control problems as mere control or significant deficiencies. Improved regulation, more robust and independent audits, and heightened awareness of the impact of control deficiencies may be why the majority of the more recent disclosures are being categorized as material weaknesses. As SOX 404 compliance neared and the magnifying glass of regulation intensified the focus on internal controls, an increasing

[4] Public Company Accounting Oversight Board (PCAOB) Auditing Standard No. 2, Paragraph 10.

number of companies not only disclosed control deficiencies but also conceded they rose to the severity of a material weakness.

Table 3 shows the three types of deficiencies disclosed sorted by market capitalization. The most severe deficiencies existed at smaller companies. Of the 432 companies with market capitalizations of less than $75M disclosing control deficiencies, 82% disclosed material weaknesses. Of the 280 companies with market capitalizations between $75M and $300M disclosed control deficiencies, 86% reported material weaknesses. Of the 241 companies with market capitalizations of more than $700M making control deficiency disclosures, 75% reported material weaknesses.

Table 3: Type of Control Deficiency by Market Capitalization

	Number of Deficiencies				Percentage of Total Deficiencies		
Market Capitalization	**Material Weakness**	**Significant Deficiency**	**Other Control Deficiency**	**Total Deficiencies**	**Material Weakness**	**Significant Deficiency**	**Other Control Deficiency**
Less than $75M	356	52	24	432	82%	12%	6%
$75M to $299M	242	23	15	280	86%	8%	5%
$300M to $699M	120	19	12	151	79%	13%	8%
$700M to $1.5B	80	22	6	108	74%	20%	6%
$1.5B or more	101	23	9	133	76%	17%	7%
Total	899	139	66	1,104			

Source: Glass Lewis, Company Filings.

Table 4 shows how we further classified each control deficiency into one of seven categories. Three—financial systems & procedures, personnel issues, and documentation—describe deficiencies related to a company's overall control environment. Such deficiencies adversely affect the reporting of financial information throughout a company. The categories of revenue recognition, lease accounting, and tax accounting are related to specific accounting issues. These deficiencies are isolated to the identified issue and do not impact a company's broader control environment beyond the related account balances and transactions. Our analysis of 1,104 control deficiencies disclosure made between Jan. 1, 2004, and May 2, 2005, found that revenue recognition, lease accounting, and tax accounting were the most common accounting issues connected to control deficiencies. Our final category—other—includes other company specific accounting or control issues.

Table 4: Glass Lewis Deficiency Categories and Descriptions

Deficiency Category	**Description**
Financial Systems & Procedures	Inadequate general ledger systems, accounting software, or review/cut-off procedures
Personnel Issues	Lack of competent finance/accounting staff or insufficient staffing levels
Documentation	Failure to retain adequate supporting information for accounting transactions
Revenue Recognition	Failure to apply the correct accounting guidance to revenue recognition
Lease Accounting	Failure to apply the correct accounting guidance to lease transactions
Tax Accounting	Failure to apply the correct accounting guidance to tax related issues
Other	Improper accounting for other accounting issues or other firm-specific control issues

Source: Glass Lewis. Note: Other accounting issues include derivatives, investments, pensions, employee benefits, and goodwill.

Moody's classifies control weaknesses as either Category A, those related to specific accounting issues, or Category B, those related to a company's overall control environment. From Moody's perspective, the distinction is the auditor's ability to effectively "audit around" the weakness. Auditors can use additional procedures to compensate for deficiencies in revenue recognition, lease accounting and tax accounting. Auditors cannot "audit around" deficiencies related to financial systems & procedures, personnel issues, and documentation because they are endemic throughout a company's control environment.[5] We believe deficiencies affecting a company's overall control environment are often the most severe.

[5] Moody's Special Comment – Section 404 Reporting on Internal Control: Our Early Experience, April 2005.

On average, Moody's found, companies with control deficiencies are rated three notches below (Ba3) the average for all U.S. companies rated (Baa3).[6]

Our analysis of the material weaknesses disclosed by 899 companies found many companies with multiple deficiencies. Table 5 shows the material weaknesses disclosed by companies in 2004 and 2005 sorted by category. The 899 companies with material weaknesses reported 1,464 types of deficiencies. For example, one company may have control weaknesses relating to documentation, personnel issues, and revenue recognition. The actual number of deficiencies disclosed was even greater than 1,464 because multiple deficiencies may have related to only one category.

Table 5: Classification of 899 Companies Disclosing Material Weaknesses

Material Weakness Classification	2004	2005	Total	% of Total
Financial Systems & Procedures	209	322	531	36.3%
Personnel Issues	132	208	340	23.2%
Documentation	56	64	120	8.2%
Revenue Recognition	58	86	144	9.8%
Lease Accounting	5	80	85	5.8%
Tax Accounting	33	103	136	9.3%
Other	38	70	108	7.4%
Total	531	933	1,464	

Source: Glass Lewis, Company Filings. Note: Disclosures from Jan.1, 2004, through May 2, 2005.

More than one-third of all material weaknesses were found in either financial systems infrastructure or review procedures. This category is the broadest of the seven and also includes companies failing to provide detailed descriptions of their deficiencies. The second most common type of material weakness was personnel issues; we tracked 340 companies with inadequate or unqualified accounting and finance personnel.

From an investor's point of view, material weaknesses related to revenue recognition may be the most offensive. In the 16-month period we reviewed, 144 companies reported material weaknesses connected to controls over revenue recognition policies. We find this disheartening because material weaknesses related to revenue recognition are likely to lead to restatements. In our recent Trend Alert: Restatements – Traversing Shaky Ground, we found that 17% of 2004 restatements were caused by revenue recognition errors.[7]

The SEC's enforcement of long-standing lease accounting rules, resulting in close to 300 companies correcting their erroneous accounting during the first quarter of 2005, was likely behind 80 disclosures of material weaknesses related to lease accounting in 2005.[8] Many companies in the retail and restaurant industries restated financial statements, corrected their accounting for leases, and disclosed ineffective controls regarding lease accounting. Additionally, 103 companies in 2005 had difficulty appropriately accounting for deferred tax assets and liabilities and other tax issues. While the guidance for leases and taxes were among the first pronouncements issued by FASB, companies are only now correcting past misapplication of these standards because of recent pressure from the SEC and PCAOB. Companies appear to be realizing that inappropriate industry accounting is not the same as compliance with Generally Accepted Accounting Practices.

We find it unsettling that 120 companies reported a deficiency related to documentation of their internal controls. In a company with global operations, finance and accounting staff are commonly spread throughout the world. A lack of documentation would be especially troubling in countries where significant cultural differences exist, such as Russia or China. Without documentation, how can a company and management ensure employees operate internal controls

[6] Moody's Special Comment—Section 404 Reporting on Internal Control: Our Early Experience, April 2005.

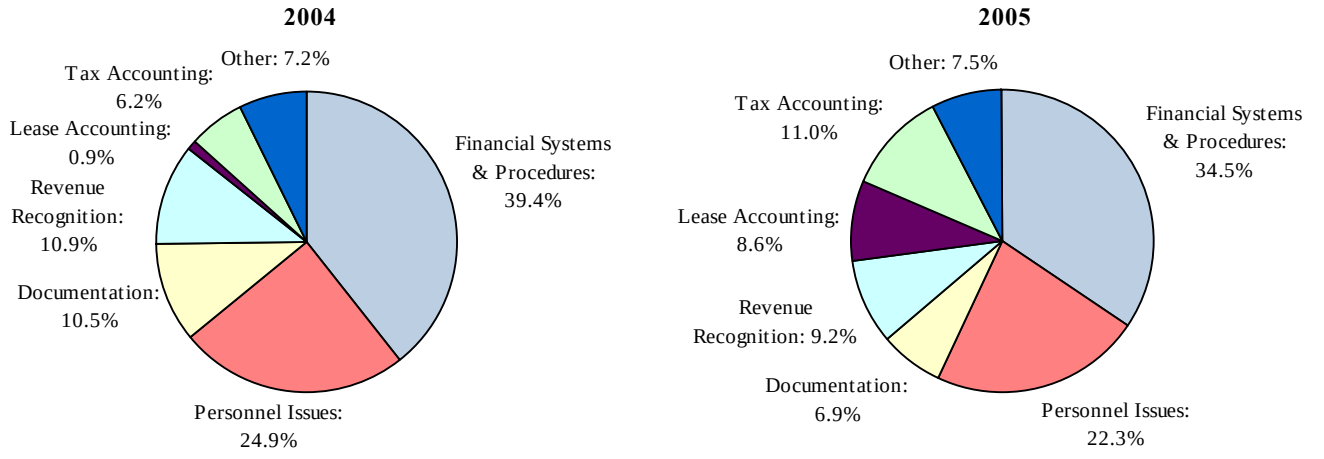
[7] Glass Lewis and Company Trend Alert: Restatements – Traversing Shaky Ground, May 2005.

[8] Many retail and restaurant companies reviewed their accounting practices for leases as a result of views expressed by the Office of the Chief Accountant of the SEC in a February 7, 2005 letter to the American Institute of Certified Public Accountants (AICPA) regarding certain operating lease accounting issues and their applicability under GAAP.

appropriately? We doubt controls can function properly when employees have not received documentation explaining controls they are to operate and have not been trained how to use them properly.

Chart 4 shows the classification categories as a percentage of the total types of deficiencies disclosed by the 899 companies reporting material weaknesses.

Chart 4: Classified Percentage of Material Weaknesses



Source: Glass Lewis, Company Filings. Note: 2005 includes disclosures through May 2, 2005.

Of these 899 companies, 411 filed their first annual report in compliance with SOX 404. Table 6 shows 351 companies received an adverse opinion on the effectiveness of internal controls and 15 received disclaimers. Auditors typically disclaim an opinion due to a limitation placed on the scope of their examination, which in the context of SOX 404 reports means management did not complete its internal control assessment in time for the auditor to finish its assessment before the annual report filing deadline.

Table 6: Auditor Opinions for Companies Disclosing Material Weaknesses

Description	Total
Adverse opinions	351
Disclaimed opinions	15
Total qualified opinions	366
Non-timely filers that expect an adverse opinion	19
Total negative opinions	385
Unqualified opinions after prior warning	45
Total known outcomes	430
Reports not yet filed:	
Late filers, no expectation given	31
Non calendar year-end	82
Non-accelerated filers	348
Other*	8
Total material weakness disclosures	899

Source: Glass Lewis, Company Filings.
* Includes companies in bankruptcy or that have withdrawn SEC registration.

Nineteen companies disclosed an incomplete control assessment but expected an adverse opinion from their auditor on the effectiveness of their internal controls. Another 31 companies filed Section 404 reports late and gave no explicit expectation of the opinion they would receive. The 50 late filing companies are listed in Appendix A.

Forty-five companies received an unqualified (clean) opinion from their auditor after previously disclosing that a material weakness existed. These companies were able to correct their problems between the time it was disclosed and year end. One company that received an unqualified opinion is **SOURCECORP (SRCP)**, a $385M business process outsourcing firm. In October 2004 and January 2005, the Company announced that its 2001 through 2004 financials should no longer be relied upon and its intention to restate prior financial statements. SOURCECORP first disclosed in its amended quarterly financials for 2004 that the restatement was indicative of a material weakness. Employees at an operating subsidiary colluded with or coerced individuals to override controls over revenue recognition, billing, and customer invoicing. SOURCECORP provided details of its remediation efforts, which had been implemented in the fourth quarter of 2004. These measures included termination of the employees involved in the collusion and a strengthening of the systems and controls surrounding revenue recognition. Management determined that the Company's internal controls were effective as of Dec. 31, 2004, because remediation actions had been completed. The Company's independent auditor, Deloitte & Touche, agreed and issued an unqualified opinion.

Our report only includes companies that have disclosed internal control deficiencies. We believe there are more companies with inadequate controls that have not disclosed their problems to investors. For example, **Island Pacific (IPI)**, a small software company, filed restated financials in the fourth quarter of 2004 due to a laundry list of errors that included revenue recognition, software amortization, royalty fees, capitalization of interest, capitalization of acquisition fees, prepaid expenses, and fair value of stock options. Despite this plethora of bad past financials, management certified the Company's controls as effective. Because Island Pacific is a non-accelerated filer, its independent auditor, Singer Lewak Greenbaum & Goldstein, was not required to issue an opinion on the effectiveness of the Company's controls in its latest annual filing. In a period of SOX 404 compliance, we question what is it going to take to make companies like Island Pacific be straightforward with investors?

Companies forewarning of control deficiencies

In preparation for compliance with SOX 404, companies began disclosing control deficiencies in press releases and quarterly filings in 2004. The upward spike in deficiency disclosures beginning in November 2004 (shown in Chart 1) was driven by calendar year-end companies using third-quarter filings to caution investors that deficiencies existed. Table 7 shows the forewarning of each type of deficiency for 2004 and so far in 2005. Of the 1,104 companies that disclosed a control deficiency, 694 gave some kind of warning prior to filing their annual reports in compliance with SOX 404. But, 360 companies with material weaknesses gave no warning to investors. (See Appendix B for a list of these companies).

Table 7: Companies Forewarning Investors of Control Deficiencies Prior to Filing of Annual Report

Descriptions	Total	% of Total
Companies disclosing material weaknesses	473	43%
Companies disclosing material weaknesses and significant deficiencies	66	6%
Total material weaknesses forewarned	539	49%
Companies disclosing significant deficiencies	107	10%
Companies disclosing other deficiencies	48	4%
Total deficiencies forewarned	694	63%
Control deficiencies not forewarned:		
Companies disclosing material weaknesses in 10-K with no prior warning	360	33%
Companies disclosing significant deficiencies in 10-K with no prior warning	32	3%
Companies disclosing other deficiencies in 10-K with no prior warning	18	2%
Total deficiencies disclosed	1,104	

Source: Glass Lewis, Company Filings.

In all, 539 companies forewarned of a material weakness or of a material weakness and significant deficiency between Jan. 1, 2004, and May 2, 2005. Sixty percent of companies with material weaknesses forewarned, 40% did not. Table 8 shows the relationship between companies that forewarned and the status of their first annual report in compliance with SOX 404.

In all, 211 of the companies that forewarned of material weaknesses filed their annual report by May 2, 2005, with an auditor opinion on internal controls or gave an expectation of the type of opinion they will receive once they do file. Close to 85% of companies that forewarned of a material weakness received a qualified opinion on the assessment of their internal controls or indicated that they will receive an adverse opinion when they do file. According to the filings we reviewed, a company forewarning investors of a material weakness is more than likely to receive an adverse opinion.

Thirty companies remain that have forewarned of material weaknesses, but have neither filed an annual report as of May 2, 2005, nor indicate the type of opinion expected. We think it is likely these companies will receive an adverse opinion once they file. We believe their apparent failure to provide more disclosure is a tremendous disservice to investors. (See Appendix A for a list of these companies).

Table 8: Forewarning Companies that Subsequently Reported a Material Weakness

Outcome	Total
Adverse opinions	148
Disclaimed opinions	9
Total qualified opinions	157
Non-timely filers that expect an adverse opinion	18
Total negative opinions	175
Companies that forewarned a material weakness but received an unqualified opinion	36
Total known outcomes	211
Reports not yet filed:	
Late filers, no expectation given	30
Non calendar year-end filers	79
Non-accelerated filers	211
Other*	8
Total material weaknesses forewarned	539

Source: Glass Lewis, Company Filings.
* Includes companies in bankruptcy or that have withdrawn SEC registration.

An alarming 57% of companies that received a qualified opinion on the effectiveness of their internal controls failed to give investors prior warning. Table 9 shows the division between companies receiving qualified opinions that forewarned and those that did not. The first time the investing public knew anything about control deficiencies at the 209 companies that did not forewarn was when they filed their annual report with a qualified opinion. More than 60% of the companies that received a qualified opinion without forewarning investors took advantage of the extensions offered by the SEC. By not providing information about the deficiencies, we believe these companies neglected to be candid with investors.

Table 9: Companies Receiving Qualified Opinions

	Adverse	Disclaimer	Total Qualified	% of Total Qualified
Companies that forewarned	148	9	157	42.9%
Companies that did not forewarn	203	6	209	57.1%
Total opinions	351	15	366	

Source: Glass Lewis, Company Filings.

In our Interim Trend Alert on Control Deficiencies published in April 2005, we noted that 87% of companies that disclosed control deficiencies in the first three months of 2005 previously certified their controls as effective as recently as the quarterly filing before the revelation of a control deficiency.[9] A similar analysis of the 366 companies that received a qualified opinion

[9] Internal Control Deficiency Disclosures – Interim Alert, April 2005.

on the effectiveness of internal controls through May 2, 2005, found that 94% had previously certified their controls as effective as recently as the quarterly filing previous to the SOX 404 annual report. In our view, the CEO and CFO of these companies were using a rubber stamp to certify the effectiveness of internal controls prior to SOX 404. We believe it took the pressure of the PCAOB on audit firms, more rigorous audits, and the implementation of SOX 404 to get the management of these companies to realize and/or disclose that their internal controls were not effective.

Market reaction to financials contaminated by control deficiencies

We considered a number of issues before measuring market reaction to the reporting control deficiencies. Goldman Sachs explained to investors the stock price movement of a company with control deficiencies depends on the nature of the problem, the market's expectations and other events surrounding the company.[10] Isolating a price change solely based on a control deficiency disclosure is difficult and is only relevant if investors are assumed to understand the ramifications of the deficiency.

As awareness spreads in the market of negative internal control disclosures, qualified auditor opinions, and how to rationally interpret the outcome, we expect stock prices to reflect this information. Since SOX 404 compliance is new, the market may need more time before it learns how to evaluate the outcome of control revelations. In subsequent years, the market may not be as forgiving as it is today toward companies that disclose material weaknesses or receive qualified opinions.

Given the restraints on measuring the market reaction to control deficiencies, the following tables summarize the reaction of stock prices to control deficiency disclosures made between January 2004 and May 2, 2005. Our analysis includes absolute stock price movement, as well as movement relative to the market (price change in excess of the market).

Table 10 shows the average absolute percentage change in stock price from seven days before the deficiency was announced out to 60 days afterward for certain groupings of control deficiencies. (See Appendix C for more statistical information related to the average.) These findings suggest there is a soak-in effect—the largest percentage decline came in the seven days before to 60 days after time period compared to the other periods. Table 10 shows the negative impact associated with deficiency disclosures appears to increase with the severity of the situation. Companies reporting a control deficiency experienced a stock decline of 2.8% on average over the next 30 days, but companies receiving a qualified opinion on the effectiveness of their controls experienced an average drop of 4.7% over the same period.

Table 10: Average Absolute Stock Price Movement from Seven Days before Announcement[11]

	1 day after	7 days after	30 days after	60 days after
All Deficiencies	-1.19%	-1.25%	-2.81%	-3.74%
Material Weaknesses	-1.27%	-1.59%	-3.76%	-5.28%
Qualified Opinions	-1.06%	-1.72%	-4.71%	-5.45%
Qualified Opinions – No Warning	-1.33%	-1.60%	-5.78%	-5.76%

Source: Glass Lewis, FactSet. Note: Averages include companies over $75M in market capitalization.
See important statistical information related to these averages in Appendix C.

The largest decline in stock price occurred for companies that received a qualified opinion without giving a prior warning of a control deficiency. For the 209 companies that gave no prior warning of deficiencies but subsequently received a qualified opinion on internal controls, stock prices declined close to 6% on average 30 days after the annual report was filed. Note that a company receiving a qualified opinion on internal controls may have also disclosed other operational or strategic problems in its annual report that could have contributed to the decline in stock price. Even with the significant decline in stock price for these 209 companies, it is difficult to draw firm conclusions on the role played by a qualified opinion. We believe, however, that such disclosures by companies that have not yet reported other issues may be an omen of future problems.

[10] Sarbanes-Oxley Section 404 – Analyzing Stock Market Reaction to Negative Disclosures, February 2005.

[11] The number of companies for which stock price data was available for each category is as follows: All Deficiencies: 663, Material Weaknesses: 535, Qualified Opinions: 326, Qualified Opinions – No Warning: 183.

The impact on stock price is less severe when analyzed relative to market movement (Table 11). Using the composite index of the exchange on which the company's stock trades, stocks of companies with qualified opinions on internal controls declined 2.3% more than the market over the 30-day time period. A stock price performing 2.3% worse than the market may be indicative that investors have penalized companies for receiving a qualified opinion on the effectiveness of internal controls.

The mere announcement of a material weakness, independent of the auditor opinion, appears to solicit a negative reaction from investors. On average, the stock price of companies disclosing material weaknesses fell 0.9% more than the market seven days after the announcement. The full effect of the material weakness disclosure was still being absorbed 30 days and 60 days later when stock prices were down an average of 2% and 4% more than the market, respectively.

Table 11: Average Stock Price Movement from Seven Days before Announcement Relative to Market[12]

	1 day after	7 days after	30 days after	60 days after
All Deficiencies	-0.72%	-0.81%	-1.50%	-3.02%
Material Weaknesses	-0.67%	-0.90%	-1.96%	-4.06%
Qualified Opinions	-0.23%	-0.66%	-2.30%	-3.56%
Qualified Opinions – No Warning	-0.04%	-0.16%	-2.49%	-3.94%

Source: Glass Lewis, FactSet. Note: Averages include companies over $75M in market capitalization.
See important statistical information related to these averages in Appendix C.

Table 12 shows investors appear to have penalized companies for not meeting the extended SEC deadlines to file their SOX 404 compliant annual reports. Using the 15-day or 45-day extension didn't seem to bother investors as much, but companies that let the March 31 or May 2 deadline pass without filing a management report or auditor opinion on the effectiveness of internal controls watched their stock price fall 7% more than the market 60 days after announcing a material weakness. The late filers include 50 companies that pre-announced material weaknesses and either 1) did not file a 404 report by the deadline but expected an adverse opinion or 2) did not file a 404 report by the deadline and gave no explicit expectation of the type of opinion the report would contain once filed. The stock price of these 50 companies (listed in Appendix A) dipped 2% more than the market the day after a material weakness was announced. Stock prices continued to fall 4% more than the market 30 days after the announcement, which is when the annual report filing deadlines passed for more than half of the companies.

Table 12: Average Stock Price Movement from 7 Days before Announcement by Filing Time Relative to Market

Filing Time of 10-K	1 day after	7 days after	30 days after	60 days after
On-time	-0.31%	-0.85%	-2.91%	-4.12%
15-day Extension	0.14%	-0.45%	-0.30%	-2.67%
45-day Extension	-0.95%	0.04%	-2.43%	-3.28%
Late Filer	-2.13%	-2.89%	-3.81%	-7.01%

Source: Glass Lewis, FactSet. Note: Averages include companies over $75M in market capitalization.
See important statistical information related to these averages in Appendix C.

We think negative market reaction to late filers is warranted. We believe companies that have severe internal control problems are more likely to issue erroneous financial statements. Control deficiencies and material weaknesses ran so deep at the late filer companies that management was not even able to complete its assessment of internal controls because it was busy discovering (and, we hope, remediating) deficiencies and weaknesses. We find it interesting that 70% of the weaknesses disclosed by the 50 late filers related to financial systems & procedures, personnel issues, or documentation. These are the types of deficiencies that tend to not be isolated, but rather are embedded in a company's control environment. Moody's classifies such material weaknesses as Category B, meaning the credit rating agency questions the ability of the auditor to

[12] The composite index used as a market proxy for each exchange is as follows: NASDAQ Composite (COMP), NYSE Composite (NYA), AMEX Composite (XAX). The NASDAQ Composite was also used for all OTC stocks.

apply compensating auditing procedures to mitigate deficiencies. Moody's also found that the most serious control problems (Category B) existed in companies that were delinquent filers.

Table 13 shows how investors may penalize companies the most for material weaknesses in internal controls related to tax accounting and personnel issues. Seven days after announcing a material weakness related to taxes, companies experienced a stock price drop of more than 2% on average. Announcements of material weaknesses due to inadequate personnel were followed by a 1.7% decline in stock price over the next seven days.

Table 13: Average Absolute Stock Price Movement from 7 Days before Announcement by Category[13]

	1 day after	7 days after	30 days after	60 days after
Financial Systems & Procedures	-0.76%	-1.14%	-2.73%	-4.66%
Personnel Issues	-1.27%	-1.72%	-3.98%	-6.14%
Documentation	-0.12%	-0.16%	-1.50%	-5.03%
Revenue Recognition	0.49%	-0.80%	-4.79%	-3.95%
Lease Accounting	-2.61%	-1.96%	-2.14%	-1.85%
Tax Accounting	-0.89%	-2.10%	-6.36%	-6.82%
Other	-3.28%	-2.72%	-1.98%	-5.04%

Source: Glass Lewis, FactSet. Note: Averages include companies over $75M in market capitalization.
See important statistical information related to these averages in Appendix C.

Table 14 shows the impact on stock price of each type of material weakness relative to market movement. Even after consideration of overall market direction, material weaknesses related to personnel issues and tax accounting stand out as factors in stock price declines. A company that announced a material weakness related to personnel issues typically experienced a drop of 0.9% more than the market the day after making the announcement and a decline of 2.3% more than the market 30 days after the announcement. On average, companies announcing material weaknesses in their tax accounting encountered a negative reaction of 4% more than the market over the next 30 days.

Table 14: Average Stock Price Movement from Seven Days before Announcement by Category Relative to Market

	1 day after	7 days after	30 days after	60 days after
Financial Systems & Procedures	-0.34%	-0.71%	-1.35%	-3.75%
Personnel Issues	-0.92%	-1.19%	-2.31%	-4.80%
Documentation	0.14%	0.12%	-0.41%	-5.29%
Revenue Recognition	1.04%	0.12%	-2.49%	-2.40%
Lease Accounting	-1.39%	-0.71%	-0.13%	-0.86%
Tax Accounting	-0.27%	-1.20%	-4.22%	-5.77%
Other	-2.59%	-2.15%	-0.06%	-3.31%

Source: Glass Lewis, FactSet. Note: Averages include companies over $75M in market capitalization.
See important statistical information related to these averages in Appendix C.

Table 15 shows another way of analyzing stock price movement related to internal control deficiencies. For all categories, the number of companies experiencing a drop of 2% or more exceeds the number of companies increasing 2% or staying within +/- 2%. As the severity of the control deficiencies increases, so does the proportion of companies that experienced a drop of more than 2%. If a company received a qualified opinion on its internal controls, our findings indicate a 60% chance of that company seeing a decline in their stock price of more than 2%.

[13] The number of companies for which stock price data was available for each category is as follows: Financial Systems & Procedures: 298, Personnel Issues: 187, Documentation: 63, Revenue Recognition: 91, Lease Accounting: 71, Tax Accounting: 105, Other: 67.

Table 15: Absolute Company Stock Price Movement from 7 Days before to 30 Days after Announcement

	All Deficiencies	Material Weaknesses	Qualified Opinions	Adverse Opinions
Stocks +2% or More	316	239	80	76
Stocks Within +/-2%	145	112	62	58
Stocks -2% or More	546	469	216	210
Total Stocks Tracked	1,007	820	358	344
No Price Data	97	79	8	7
Total	1,104	899	366	351
Stocks -2% or More as % of Total Stocks Tracked	54%	57%	60%	61%

Source: Glass Lewis, FactSet.

Companies experiencing large stock price declines

Table 16 shows the 10 largest declines in stock price for companies that first announced a control deficiency in 2005. The list is limited to companies with market capitalizations of at least $200M and revenue of at least $400M. Three interesting stories on the list include that of **R&G Financial Corp. (RGF)**, **AM Castle & Co. (CAS)** and **Standard Motor Products (SMP)**.

Table 16: Largest Decline in Stock Price for Companies Disclosing a Control Deficiency

Ticker	Company	Announce Date	7 Days Before	30 Days After	Percentage Change	Lost Market Cap ($M)	Type of Deficiency	Auditor Opinion
RGF	R&G Financial Corp.	4/29/2005	$23.50	$14.54	-38.1%	$458	Material Weakness	Unqualified*
CAS	AM Castle & Co.	3/15/2005	$16.71	$11.60	-30.6%	$80	Material Weakness	Adverse
LEXR	Lexar Media	3/31/2005	$6.32	$4.52	-28.5%	$140	Material Weakness	Adverse
PSUN	Pacific Sunwear	4/12/2005	$27.73	$20.35	-26.6%	$541	Control Weakness	Unqualified
OMG	OM Group	3/31/2005	$29.00	$21.94	-24.3%	$201	Material Weakness	Late filer, no expectation
USMO	USA Mobility	3/17/2005	$39.25	$29.74	-24.2%	$254	Control Weakness	Unqualified
SMP	Standard Motor Products	3/31/2005	$11.79	$9.08	-23.0%	$52	Material Weakness	Disclaimer
ACO	Amcol International	3/15/2005	$22.30	$17.20	-22.9%	$149	Material Weakness	Adverse
WFR	MEMC Electronic Materials	3/16/2005	$14.51	$11.23	-22.6%	$675	Material Weakness	Adverse
UTSI	UTStarcom Inc.	3/14/2005	$13.68	$10.74	-21.5%	$333	Material Weakness	Adverse

Source: Glass Lewis, FactSet. Note: Table limited to companies with more than $200M in market capitalization and $400M in revenue.
* R&G Financial Corp. received an unqualified opinion in 10-K filed 3/16/2005 and now expects an adverse opinion as of 8-K filed 4/29/2005.

R&G Financial announced a delay in its first quarter 2005 earnings release on April 25, 2005, and its intention to restate financials from 2003 through 2004 due to inappropriate valuation of residual interests in its derivative securities. Four days later, the Company determined the restatement was indicative of a material weakness, despite certifying in its March 16 10-K filing that internal controls were effective. R&G Financial received a clean opinion on internal controls from PwC, but after the restatement and material weakness came to light the Company determined that its controls were ineffective and stated it expects to receive an adverse audit opinion. Company stock fell $8.14 (35%) the day the restatement was announced. From seven days before to 30 days after announcing a material weakness existed in internal controls, R&G Financial stock declined $8.96 (38%), representing a loss in shareholder wealth of $458M.

AM Castle, an industrial distributor of specialty metals, announced in its March 15 earnings release that a material weakness existed in its internal controls related to inventory valuation. AM Castle implemented an improved inventory system in the second half of 2004 leading to third and fourth quarter inventory write-offs to correct the previous valuation of inventory. The write-offs reduced after-tax earnings by $2.4 million in the fourth quarter of 2004. In addition, the Company's auditors found deficiencies relating to the financial close and reporting process, findings that led to adjustments to the financial statements. A day after the earnings release, AM Castle filed its annual report with an adverse opinion by Deloitte & Touche on the effectiveness of internal controls. The Company's stock dropped more than 30% over the next 30 days from its value seven days before filing the earnings release.

Standard Motor Products, a manufacturer in the automotive aftermarket with 2004 sales of $824M, reported in its annual report on March 31, 2005, that material weaknesses existed in controls due to insufficient accounting personnel, ineffective controls over the information technology environment and financial closing process. In November 2004, Standard Motor Products' independent auditor, Grant Thornton, notified the Company's audit committee that deficiencies existed relating to the IT environment. However, management assured shareholders they had "no reason to believe that these deficiencies resulted in (a) a material weakness in internal controls or (b) any material inaccuracy to the financial statements." Four months later, after taking advantage of the 15-day SOX 404 filing extension, Standard Motor Products disclosed in its annual report that its internal control problems were deeper than first disclosed. The deficiency related to insufficient accounting personnel in fact constituted a material weakness. The Company's stock price fell 23% from 7 days before to 30 days after the filing of its annual report. KPMG, the Company's previous auditors, resigned in September 2004. Because Standard Motor Products' management was unable to complete its assessment of internal control, Grant Thornton was not able to issue an opinion on internal controls due to a scope limitation and therefore disclaimed an opinion.

Table 17 shows the immediate impact of a deficiency announcement on stock price, focusing on the immediate previous and following days. It includes the 10 largest price declines over this time period for companies disclosing control deficiencies.

Table 17: Largest Initial Decline in Stock Price

Ticker	Company	Announce Date	Day Before	Day After	Percentage Change	Lost Market Cap ($M)	Type of Deficiency	Category
ADO	Adecco SA	1/12/2004	$16.93	$11.76	-30.5%	$3,867	Material Weakness	Fincl Sys & Proc
MCIP	MCI	4/29/2004	$17.00	$14.18	-16.6%	$888	Material Weakness	Documentation, Tax
FOE	Ferro Corp.	7/23/2004	$24.68	$20.68	-16.2%	$168	Significant Deficiency	Personnel Issues
USMO	USA Mobility	3/17/2005	$39.59	$33.70	-14.9%	$158	Control Deficiency	Fincl Sys & Proc
LIN	Linens N Things	3/11/2005	$26.30	$22.65	-13.9%	$165	Material Weakness	Lease
KKD	Krispy Kreme Doughnuts	4/19/2005	$7.14	$6.19	-13.3%	$60	Material Weakness	Fincl Sys & Proc
NDN	99 Cents Only Stores	3/8/2005	$15.26	$13.25	-13.2%	$140	Material Weakness	Fincl Sys & Proc, Documentation
PPD	Pre Paid Legal Services	2/22/2005	$35.21	$30.73	-12.7%	$70	Material Weakness	Documentation
GT	Goodyear Tire & Rubber Co	2/11/2004	$9.92	$8.70	-12.3%	$214	Material Weakness	Fincl Sys & Proc, Personnel Issues
MRCIY	Marconi Corp PLC	3/10/2004	$25.50	$22.75	-10.8%	$275	Control Deficiency	Other

Source: Glass Lewis, FactSet. Note: Table limited to companies with over $200M in market capitalization and $400M in revenue.

Switzerland-based **Adecco SA (ADO)** leads the list with a plummet of more than $5.00 (30.5%) in stock price, a catastrophic loss in shareholder wealth of $3.8B over a 48-hour period. Adecco, the world's largest employment agency and a Forbes Global 500 company, in January 2004 announced a delay in the audit and reporting of its fiscal 2003 results. The primary reason was the discovery of a material weakness in the North American operations of Adecco Staffing. Adecco Group's auditors, Ernst & Young, identified material weaknesses relating to the financial statement close process, IT system security,

reconciliation procedures, cash application and revenue recognition in the North American staffing operations. In its 2004 annual report, Adecco reported that the company has corrected and fully addressed the identified weaknesses, but the Company's stock has not bounced back enough to recover the cost sustained by investors.

Ferro Corp. (FOE), a global producer of technology-based performance materials for end markets, took a charge to earnings in its second quarter 2004 (issued in July 2004) to correct inappropriate accounting entries that overstated business performance. The Company will be late in filing its 2004 reports and its first 2005 quarterly report because it first plans to restate financial reports for fiscal 2003 and first quarter 2004. Ferro Corp.'s stock fell $4.00 (16.2%) from the closing price the day before to the closing price the day after the announcement, a $168M drop in market capitalization.

One-price retailer **99 Cents Only Stores (NDN)** announced in March 2005 it was reviewing its accounting for operating leases in light of comments made by the chief accountant of the SEC. Four months earlier, the Company had stated that deficiencies related to inventory and accounts payable accounting procedures had been corrected. In the 2005 announcement, 99 Cents Only Stores warned of a potential restatement related to its current misapplication of GAAP concerning leases and also updated its progress on SOX 404 compliance. Management did not finish its assessment of internal controls, but did disclose that material weaknesses existed in the control environment, documentation procedures, and information systems. The Company's financial reporting difficulties appear to run deep; 99 Cents Only Stores has not filed a financial report since the third quarter of 2004. The delay in reporting annual and quarterly performance to investors, driven by deficiencies in its control environment, caused an initial decline in 99 Cents Only Stores stock of $2.01 (13.2%) and a decline of more than 20% from 7 days before to 30 days after the announcement—a market capitalization loss of $140M. The Company has yet to provide investors with details of how it will remediate the disclosed weaknesses. Had 99 Cents Only Stores done so, similar to the company shown in Appendix D, investors may not have penalized it so heavily.

Executive compensation despite control deficiencies

Clearly, as we've seen above, murky disclosure of internal control deficiencies can cost investors plenty. That is not necessarily the case with executives responsible for ensuring that proper controls exist in the first place. Despite overseeing ineffective financial controls or certifying as effective controls that are not, executives continue to be awarded bonuses and stock-based compensation for "good performance." We don't think such incentive-based compensation is warranted when underperformance is evident. Table 18 shows three companies that received qualified opinions on internal controls effectiveness, but still awarded their CFOs with raises and bonuses.

Table 18: CFO Compensation at Companies Receiving a Qualified Opinion

			Started	2004 Compensation			2003 Compensation		
Company Name	**Name**	**Title**	**as CFO**	**Salary**	**Bonus**	**Stock**	**Salary**	**Bonus**	**Stock**
Baxter Internat'l (BAX)	John J. Greisch	CFO	Jun 2004	$436,154	$418,700	$688,699	$0	$0	$0
Blockbuster, Inc (BBI)	Larry J. Zine	CFO	Nov 1999	$594,808	$675,000	$0	$568,000	$673,946	$1,284,690
Lexar Media (LEXR)	Brian T. McGee	CFO	May 2003	$247,692	$44,892	$2,028,696	$119,231	$142,385	$2,447,052

Source: Glass Lewis, Company Filings

Baxter International (BAX), a $9.5B medical equipment and supplies manufacturer, announced in March 2005 its intentions to restate its financial statements from 2001 through 2003. The cause was errors related to income tax accounting severe enough that management determined a material weakness existed in internal controls. Despite the $108M restatement and the issuance of a qualified opinion by PwC, Baxter's still awarded CFO John Greisch a bonus almost as large as his base salary and nearly $700,000 in stock-based compensation. Shareholders, on the other hand, lost $933M in market capitalization over the two-week period surrounding the announcement of a material weakness and financial restatement.

Blockbuster, Inc (BBI), like many retailer and restaurant companies, found itself correcting past misapplication of accounting for operating leases in early 2005. Even though CFO Larry Zine had consistently signed-off on financial statements that violated GAAP, his compensation didn't seem to suffer. While Mr. Zine was not awarded the hefty, stock-based bonus he received in 2003, his salary and cash bonus increased in 2004. For corporate practices like these, we awarded

Blockbuster our worst grade—an "F"—for executive compensation out of the 4,300 companies in the Glass Lewis universe during the past year.

Lexar Media (LEXR) disclosed a material weakness in its annual report related to revenue recognition controls. Specifically, its controls over recording revenue from the sale of its products by resellers, accounting for price reductions, and tracking promotional commitments were inadequate. The revenue recognition deficiencies, among the most severe to investors, didn't have the affect on CFO Brian McGee's compensation one might expect. The Company still granted Mr. McGee more than $2M in stock-based compensation and his base salary more than doubled from 2003 to 2004.

The above companies are examples of what we see as inappropriate executive compensation. Each company received an "F" in our annual Pay-For-Performance evaluation, which scores a company's compensation practice relative to business performance and its peer group. An analysis of the 1,104 companies that disclosed control deficiencies found that our average grade for executive compensation worsens progressively with the severity of the situation. Table 19 shows our average Pay-For-Performance Score and Grade for companies with control deficiencies. The average score for companies receiving a qualified opinion was 0.548 (based on a scale of 0=A to 1=F). This compares to an average score of 0.499 for the 4,300 companies we rate. Using this analysis, we believe the three companies described above are not alone in overpaying their executives for poor maintenance of effective controls.

Table 19: Glass Lewis Average Pay-For-Performance Score for Companies with Control Deficiencies

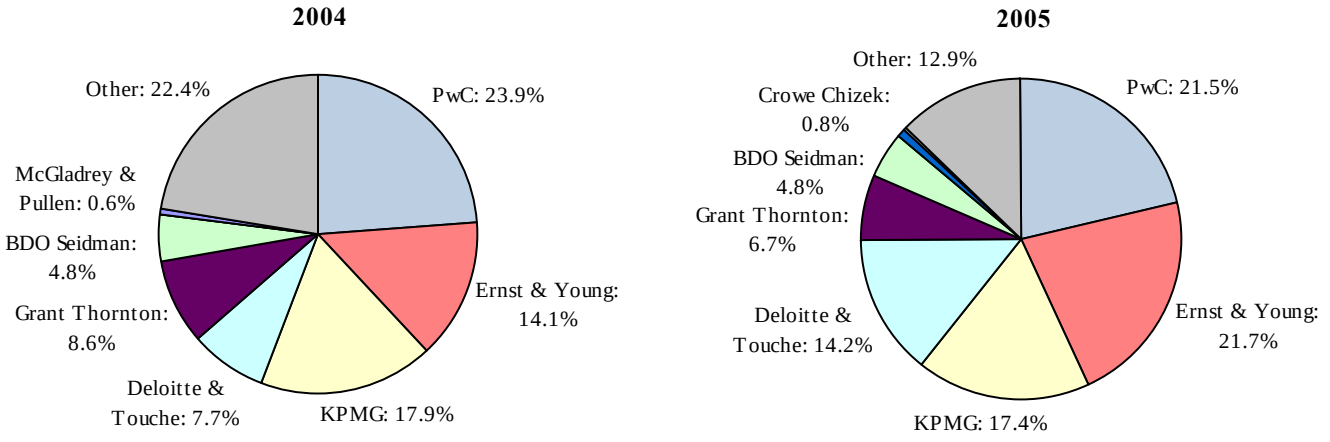
	Score	Grade
Control Deficiency	0.534	C
Material Weakness	0.536	C
Qualified Opinion	0.548	C
Glass Lewis Universe	0.499	C

Source: Glass Lewis

Auditor role in testing the water for control deficiencies

During this initial compliance period, auditors appear to have been more insistent than in the past about ensuring disclosure of internal control deficiencies and classifying them as material weaknesses. Before SOX 404, companies had to only disclose deficiencies when discussing an auditor termination, meaning investors did not know about potential problems unless an auditor change occurred. Chart 5 shows the 899 companies reporting material weaknesses by audit firm.

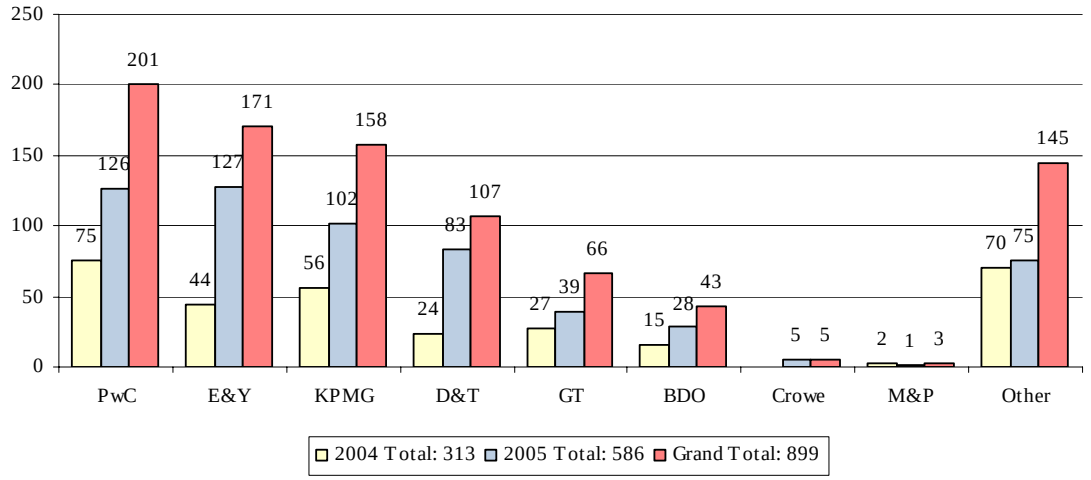
Chart 5: Proportion of Material Weakness by Audit Firm



Source: Glass Lewis, FactSet. Note: 2005 includes disclosures through May 2, 2005.

Chart 6 shows the number of companies disclosing material weaknesses by audit firm.

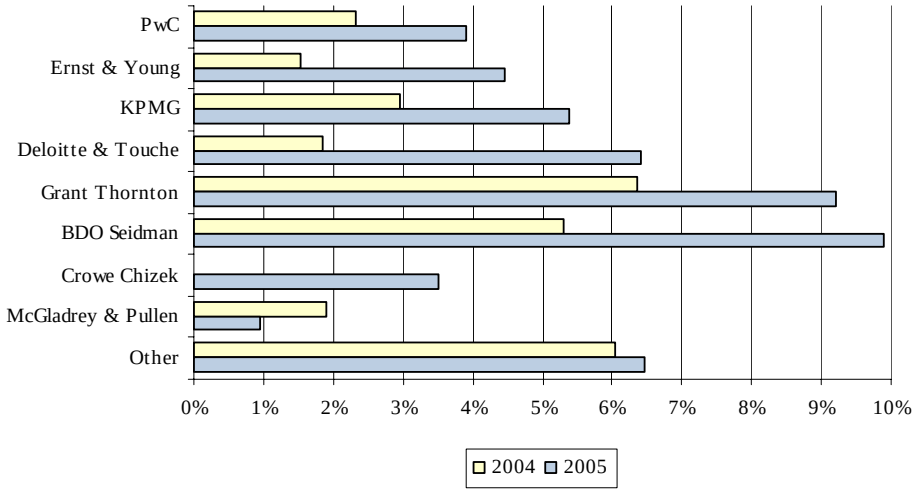
Chart 6: Number of Companies with Material Weaknesses by Audit Firm



Source: Glass Lewis, FactSet. Note: 2005 includes disclosures through May 2, 2005.

Chart 7 shows the rate at which audit firms have disclosed material weaknesses for the last two years. By May 2, 2005, for example, about 6.5% of public companies audited by Deloitte & Touche disclosed material weaknesses. In 2004, by comparison, only 2% of companies audited by Deloitte & Touche disclosed a material weakness. Overall, in 2005 between 4% and 5% of the companies audited by the other three Big 4 firms disclosed material weaknesses. Given the large increases in 2005 of material weakness disclosures, we question how forceful the Big 4 have historically been in identifying material weaknesses (or at least requiring their clients to disclose them). We think it's fair to say that most of the weaknesses disclosed in 2005 did not develop overnight, especially those related to a company's overall control environment.

Chart 7: Rate of Material Weaknesses by Audit Firm[14]



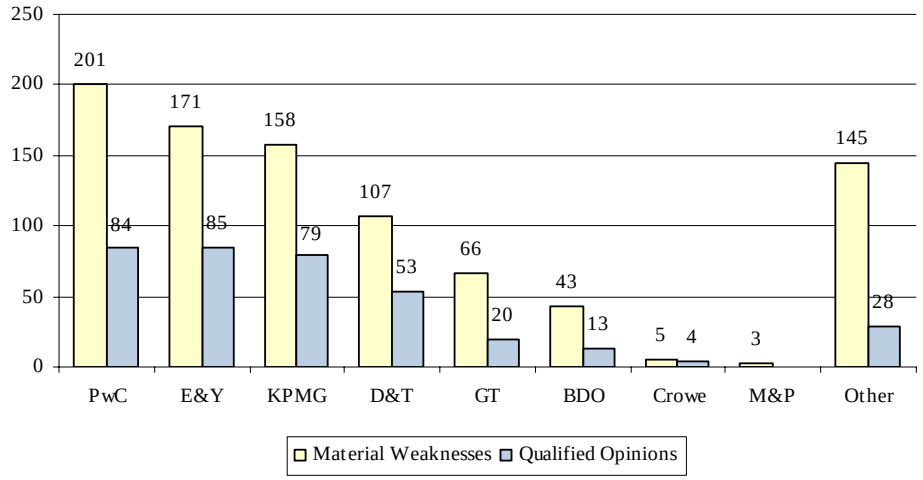
Source: Glass Lewis, FactSet, Public Accounting Report. Note: 2005 includes disclosures through May 2, 2005.

[14] Rate based on 11,392 total SEC filers audited by the top 100 audit firms reported by *Public Accounting Report*. See Appendix F for more details.

The Tier 2 firms of BDO Seidman and Grant Thornton far exceed their peers in the number of disclosures as a percentage of companies audited. About 10% of each firm's audited companies disclosed material weaknesses. We believe the high percentage could be due to a number of factors, including company size, audit quality and disclosure rule enforcement.

When analyzing auditor deficiency disclosure rates, we believe the number of qualified opinions (adverse and disclaimed) issued indicates the rigor of the audit. Chart 8 shows the number of companies per audit firm that disclosed material weaknesses compared to the number that received a qualified opinion on the effectiveness of internal controls.

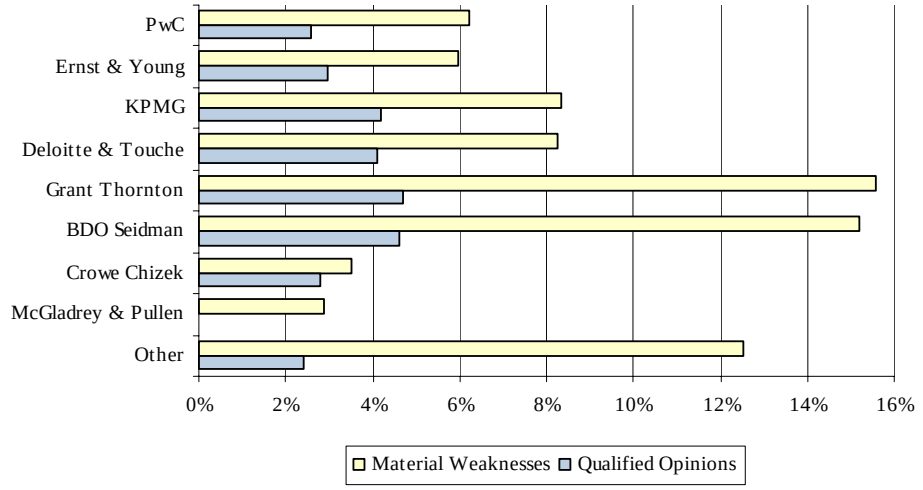
Chart 8: Companies Disclosing Material Weaknesses vs. Qualified Opinions Received by Audit Firm



Source: Glass Lewis, FactSet. Note: 2005 includes disclosures through May 2, 2005.

Chart 9 shows the percentage of companies audited disclosing a material weakness in 2004 or 2005 compared to those that received a qualified opinion. KPMG and Deloitte & Touche issued qualified opinions for 4% of their companies, 1% more than PwC and Ernst & Young. Grant Thornton and BDO Seidman issued qualified opinions for about 5% of their companies.

Chart 9: Rate of Material Weaknesses Disclosed vs. Qualified Opinions Received by Audit Firm



Source: Glass Lewis, FactSet, Public Accounting Report. Note: 2005 includes disclosures through May 2, 2005.

When the rates of material weakness disclosure and restatement are compared by auditor, some commonalities emerge. Deloitte & Touche and BDO Seidman, for example, have the most companies restate financials as a percent of the number of companies audited (7%).[15] The two firms also have high material weakness and qualified opinion rates.

Our analysis of the 366 qualified opinions received by companies with poor internal controls shows no firm stands out as issuing significantly more qualified opinions relative to the number of companies it audits. PwC, for example, issued 23% of the qualified opinions; it audits about 25% of companies registered with the SEC.

As a percentage, the number of qualified opinions issued by auditor varies little among the Big 4 firms. Each issued a qualified opinion for 3% to 4% of its company base. Table 20 shows the number of qualified opinions issued by each firm.

Table 20: Qualified Opinions by Audit Firm

Audit Firm	Total	Qualified as % of Total	Public Cos Audited*	Qualified as % of Public Cos Audited
PwC	84	23.0%	3,234	3%
Ernst & Young	85	23.2%	2,856	3%
KPMG	79	21.6%	1,893	4%
Deloitte & Touche	53	14.5%	1,296	4%
Grant Thornton	20	5.5%	424	5%
BDO Seidman	13	3.6%	283	5%
Crowe Chizek	4	1.1%	143	3%
McGladrey & Pullen	0	0.0%	105	0%
Other	28	7.7%	1,158	2%
Total	366	100.0%	11,392	3%

Source: FactSet, Company Filings. * Public Accounting Report, GLC. Qualified opinions as of 5/2/2005

Size of companies disclosing control deficiencies

The SEC does not require non-accelerated filers, generally companies with less than $75M market capitalizations, to file annual reports with an auditor attestation on the effectiveness of internal controls until the filer's annual report for their first fiscal year-ending after July 15, 2006.[16]

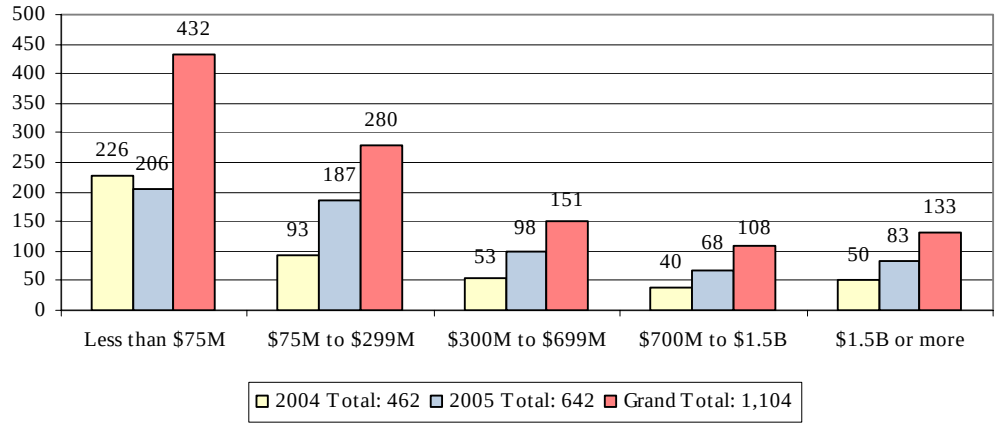
For calendar year-end companies, this means investors will not receive a report on the adequacy of internal controls from the independent auditor until the first quarter of 2007, almost five years after SOX was passed by Congress and almost 30 years after Congress passed the FCPA.

Nonetheless, it should be a concern to investors and regulators that companies with market capitalization of $75M or less made close to 40% of the internal control deficiency disclosures over the 16-month period we reviewed. Chart 10 shows disclosures broken down by market capitalization.

[15] Glass Lewis and Company Trend Alert: Restatements – Traversing Shaky Ground, May 2005.

[16] SEC Release No. 34-51293. The deadline was also extended for foreign private issuers filing annual reports on Form 20-F or 40-F.

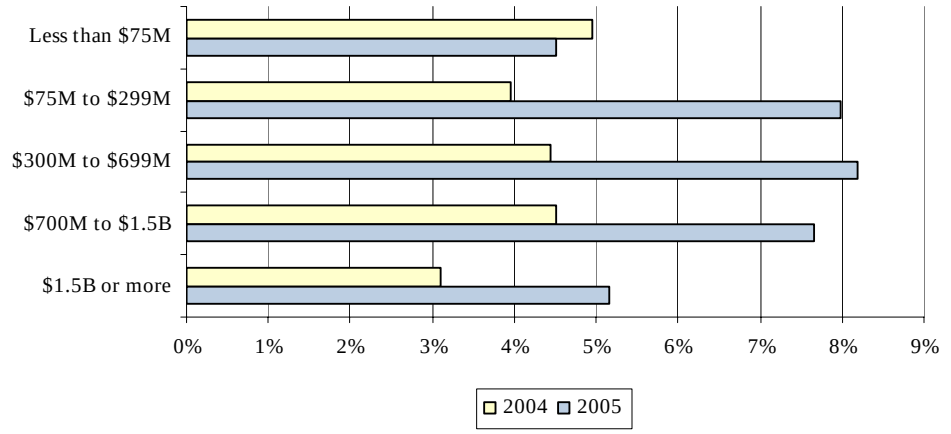
Chart 10: Number of Control Deficiency Disclosures by Market Capitalization



Source: Glass Lewis, FactSet, Company Filings. Note: 2005 includes disclosures through May 2, 2005.

The largest deficiency rate (number of companies per total publicly traded SEC filing companies) is for companies with market capitalizations between $75M and $1.5B. Close to 8% of companies in this range disclosed control deficiencies in 2005. In all, 11% of publicly traded companies with market capitalizations greater than $75M disclosed internal control deficiencies during the 16-month period. Chart 11 shows the deficiency rate by market capitalization.

Chart 11: Rate of Control Deficiency Disclosures by Market Capitalization[17]

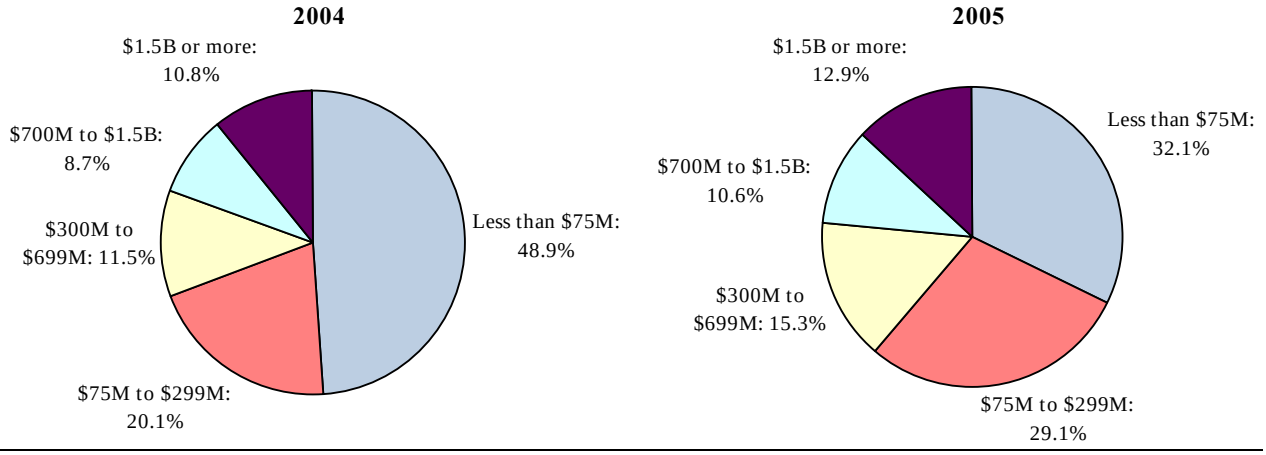


Source: Glass Lewis, FactSet. Note: 2005 includes disclosures through May 2, 2005.

Chart 12 shows the proportion of control deficiency disclosures made within market capitalization segments. SOX 404 compliance significantly affected companies with market capitalization greater than $75M from 2004 to 2005. In 2004 these companies accounted for about 51% of all deficiency disclosures; in 2005 they made up about 68%.

[17] Rate based on an estimated 10,602 publicly traded SEC filing companies obtained using FactSet. See Appendix F for more details.

Chart 12: Proportion of Control Deficiency Disclosures by Market Capitalization

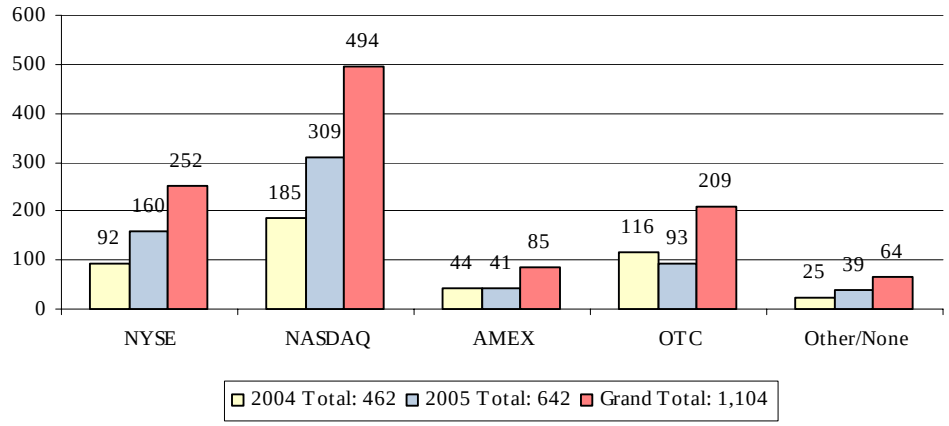


Source: Glass Lewis, FactSet, Company Filings. Note: 2005 includes disclosures through May 2, 2005.

Marketplace for companies with control deficiency disclosures

Our data shows companies trading on the NASDAQ were more likely to report a control deficiency. Close to 500 companies traded on the NASDAQ reported control deficiencies in the last 16 months. Chart 13 shows the number of companies disclosing control deficiencies on each major stock exchange.

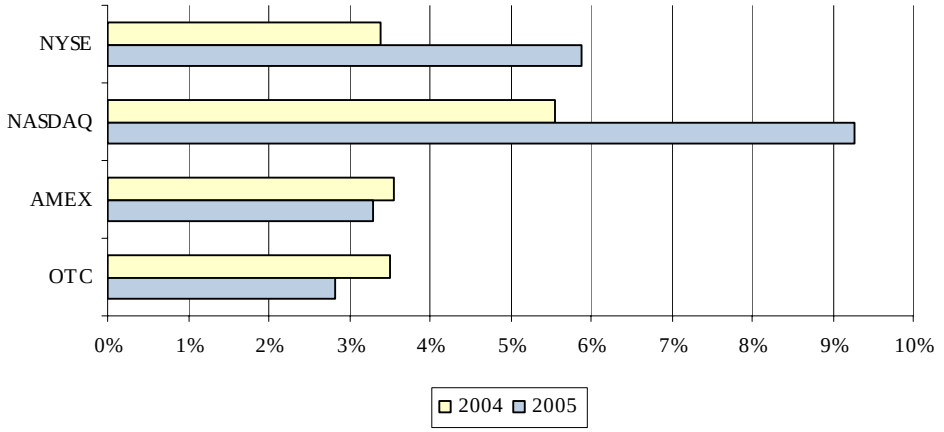
Chart 13: Number of Control Deficiency Disclosures by Stock Exchange



Source: Glass Lewis, FactSet. Note: 2005 includes disclosures through May 2, 2005.

Chart 14 shows the percentage of companies trading on each respective exchange that disclosed a control deficiency in 2004 and 2005. The NASDAQ has seen more than 9% of its registrants disclose deficiencies in 2005.

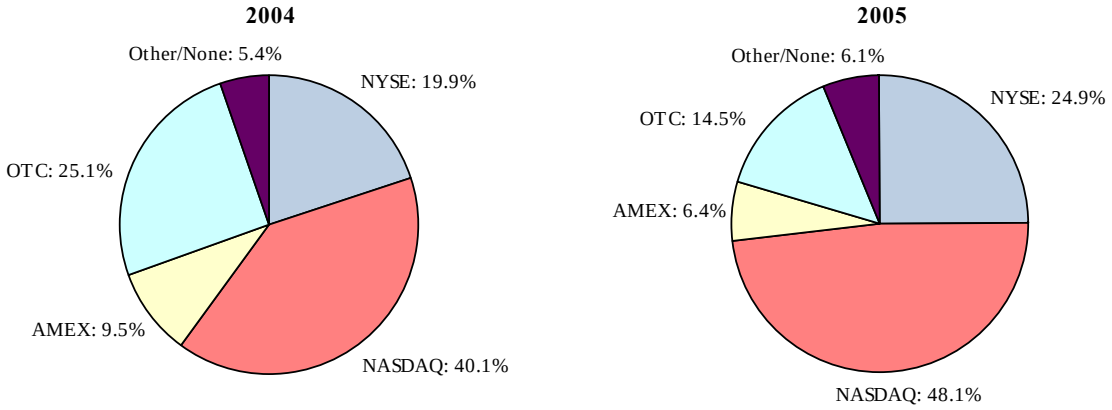
Chart 14: Rate of Control Deficiency Disclosures by Stock Exchange[18]



Source: Glass Lewis, FactSet. Note: 2005 includes disclosures through May 2, 2005.

Chart 15 shows that almost half the deficiency disclosures made in 2005 came from companies that trade on the NASDAQ. About one-quarter were made by companies trading on the NYSE.

Chart 15: Proportion of Control Deficiency Disclosures by Stock Exchange



Source: Glass Lewis, FactSet. Note: 2005 includes disclosures through May 2, 2005.

Accuracy and reliability are worth compliance costs

Companies appear to be cleaning up their financial reporting systems and internal controls. They are discovering weaknesses and correcting them in efforts to ensure the accuracy of reported information. SOX 404's control requirements are resulting in enhanced reliability of financial statements, improved operational effectiveness of businesses and increased public confidence in capital markets. Despite these benefits, the business community continues to obsess on the compliance cost. One study estimated that, on average, companies are spending $4.4M to implement the internal control requirements of Sarbanes-Oxley.[19] A separate research project found that large companies spent an average of $7.8M on Section 404

[18] Rate based on an estimated 10,602 publicly traded SEC filing companies obtained using FactSet. See Appendix F for more details.

[19] FEI Special Survey on Sarbanes-Oxley Section 404 Implementation, March 2005, Financial Executives International. Survey included 217 companies with average revenue of $5 billion.

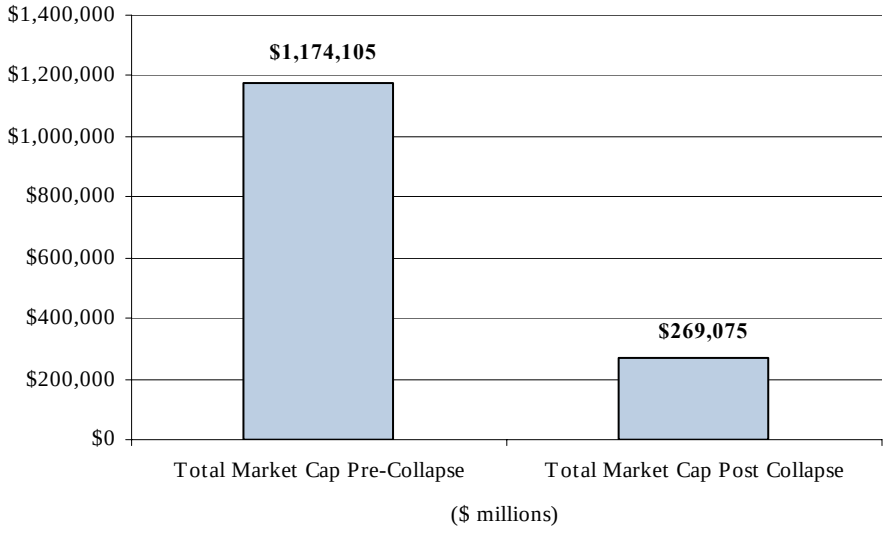
compliance in 2004.[20] These costs, which are widely considered start-up expenses, reflect the lack of financial reporting control and procedures that existed prior to implementation of SOX 404. In fact, both studies found that SOX 404 compliance costs are estimated to drop by 40-45% in 2005.[21] Once companies invest in the initial implementation of improved controls, we expect the business community's SOX 404 grousing to subside.

Smaller companies are often the most vehement in arguing the cost of SOX 404 compliance outweighs its benefits. Ironically, some of the most egregious problems with internal control systems exist at smaller companies. To address this issue, the SEC established an Advisory Committee on Small Public Companies and a COSO framework for small business is targeted for release in September 2005.[22]

Compliance costs will likely decline as companies fix problems and auditors become more efficient. The high number of control deficiency disclosures about inadequate financial systems and lack of competent personnel may explain why the initial compliance was so expensive. Companies appear to have included basic financial infrastructure costs in their tally of SOX 404 expenses. Auditing firms have stated they did not integrate the control audit along with the financial statement audit. We believe costs will decline as the two audits combine.

However, we believe when companies and regulators consider the cost vs. benefit debate of SOX 404, they should remember how erroneous financial information led to enormous equity losses in recent years. Chart 16 shows the market capitalizations of 30 now infamous companies before and after their financial gaffes were exposed.

Chart 16: Shareholder Losses from 30 Major Accounting Scandals from 1997 to 2004



Source: Glass Lewis, FactSet. See Appendix E for detailed information about the companies included in the chart.

The erosion of $905B in shareholder value shown above does not include additional losses to investors in debt of companies such as Enron, Worldcom, and Adelphia. For example, in a recent filing disclosing MCI's emergence from bankruptcy and

[20] Sarbanes-Oxley Section 404 Costs and Remediation of Deficiencies, April 2005, Charles River Associates. Sample consisted of 90 Fortune 1000 companies averaging $8.1 billion in revenue.
[21] FEI Special Survey on Sarbanes-Oxley Section 404 Implementation, March 2005, p. 4. Sarbanes-Oxley Section 404 Costs and Remediation of Deficiencies, p. 5.
[22] Currently there is only one Integrated Framework for Internal Control developed by The Committee of Sponsoring Organizations (COSO) of the Treadway Commission by which management and auditors in the U.S. follow for the assessment of internal controls.

its adoption of fresh-start accounting, the company reported that debt holders received $5.5B in new debt and $8.7B in preferred stock in exchange for $37.5B of outstanding debt. On face value, that's another $23.3B loss sustained by investors.

Conclusion

Contaminated financial information has inflicted monetary damage and diminished investor confidence in the capital markets. Compliance with SOX 404 appears to have brought to light internal control deficiencies at more than 1,100 public companies. Given that nearly 10% of public companies disclosed control deficiencies, financial statements were not as clean as we thought, and consequently, may need to be filtered by careful analysis.

The costs of SOX 404 compliance should be considered an investment in the capital markets. In the first year of compliance, companies appear to be spending on basic internal control infrastructure such as appropriate financial systems and experienced personnel. Once these fundamental, but integral control components are in place, compliance costs should drop. Also, as auditors integrate audits of financial statements and controls, total fees should decline.

We find that executives who failed in their obligation to comply with federal laws mandating adequate controls have often not been held accountable. While the costs of determining and remediating such noncompliance have risen, compensation for such executives has often risen as fast or faster.

On average, companies experienced a negative market reaction when they announced control deficiencies. The remediation of these deficiencies should help limit exposure to flawed financial information. We believe investors should stay informed of management's and independent auditors' annual evaluation of internal controls, as well as the progress made on remedial efforts. Because it is still early in the era of SOX 404 compliance, we hope policymakers will allow the benefits to fully materialize before making any rash decisions that may again compromise the purity of financial information.

Appendix E: Market Capitalization Losses

Stock prices can be substantially impacted when the integrity and credibility of financial information is in doubt. When investors learn amounts reported in financial statements are incorrect, they may revise their assessment on the perceived value of the firm in question. Two separate analyses have been performed (Tables E1 and E2), which assess the market impact of impure financials. The first table looks at the immediate, short-term impact, while the second table evaluates the longer-term effects.

Shareholder losses based on date accounting issue announced

The first analysis reviews the impact on stock prices when a Company, or another external source, announces that accounting problems exist at the Company. Table E1 measures the decline in market capitalization during the period beginning two days prior to the announcement of the intention to restate financials or, in the absence of such an announcement, the filing date, and ending five days following that date. The analysis concludes that when an announcement is made that calls into question the reliability of financial reporting, the loss to investors can be substantial. Of the 30 companies reviewed in this study, the market capitalization lost between the two days prior to the reporting of a restatement and the five days following that date was $95B, or 27%.

Table E1: Market Cap Declines from Two Days Before to Five Days After Disclosure of Accounting Events

Company Name	Ticker	Announcement Date	7 day Mkt Cap Loss ($ in millions)	Cumulative Return
Global Crossing (1)	GX	7/27/01	(281.8)	-4.2%
Krispy Kreme (2)	KKD	5/7/04	(712.9)	-35.9%
Critical Path (3)	CPTH	2/6/01	(20.3)	-15.6%
Network Associates (4)	MFE	12/26/00	(774.2)	-53.3%
Rite Aid (5)	RAD	10/11/99	(841.5)	-25.2%
Lernout & Hauspie (6)	LHSP	9/21/00	(1,243.1)	-53.5%
Symbol Technologies (7)	SBL	2/13/02	(1,416.5)	-43.9%
Health South (8)	HLSH	8/27/02	(2,546.8)	-53.6%
Oxford Health Plans (9)	OHP	10/28/97	(3,444.5)	-63.2%
Adelphia (10)	ADELQ	3/27/02	(1,702.1)	-52.5%
MicroStrategy (11)	MSTR	3/20/00	(17,495.6)	-54.6%
Waste Management (12)	WMI	7/7/99	(12,729.4)	-37.3%
Cendant (13)	CD	4/15/98	(12,048.9)	-39.0%
Qwest (14)	Q	6/20/01	(6,751.8)	-11.9%
WorldCom (15)	WCOM	6/26/02	(6,962.7)	-100.0%
Enron (16)	ENE	10/12/01	(6,839.6)	-26.0%
Tyco (17)	TYC	1/14/02	(9,682.3)	-9.3%
Peregrine Systems (18)	PRGN	5/6/02	(198.4)	-39.2%
McKesson HBOC (19)	MCK	4/28/99	(7,944.0)	-44.4%
Sunbeam (20)	SOC	4/3/98	(1,575.4)	-35.5%
Fannie Mae (21)	FNM	9/20/04	(10,277.5)	-13.0%
AIG (22)	AIG	2/14/05	(16,804.3)	-11.2%
Elan (23)	ELN	1/29/02	(5,166.6)	-63.5%
Dynegy (24)	DYN	4/3/02	192.4	4.4%
Nortel (25)	NT	3/15/04	(4,916.7)	-18.5%
Bristol-Myers Squibb (26)	BMY	4/2/02	(17,775.9)	-22.1%
El Paso (27)	EP	6/7/02	(785.6)	-8.6%
Xerox (28)	XRX	6/16/00	(3,692.6)	-22.0%
Purchase Pro (29)	PRO	2/4/01	(3,806.2)	-40.8%
Homestore (30)	HOMS	12/21/01	(45.8)	-12.8%
	TOTAL		(95,211.7)	-27.4%

Source: GLC, Capital IQ, BigCharts.com. Note: Companies in the above table were selected based on the large market capitalization changes associated with their accounting announcements. The data is not adjusted for other market changes occurring during the respective time periods affecting each firm.

(1) July 27, 2001, the former VP of Finance sent a letter to the Company alleging fraud.
(2) May 7, 2004, the Company announced first quarter earnings shortfall.
(3) February 6, 2001 the Company announced that the Board was investigating the revenue recognition practices.
(4) December 26, 2000, the Company announced at its earnings press release senior management changes and that it would change its revenue recognition policy.
(5) March 12, 1999, the Company announced an earnings shortfall for the 4th qtr.
(6) September 21, 2000, the Wall Street Journal reports that an SEC probe of L&H's financial statements is in the works.
(7) February 13, 2002, Newsday, Inc. issued an article about accounting problems at the Company.
(8) August 27, 2002, the Company announced an earnings shortfall for fiscal year 2002 and that it was replacing the CEO.
(9) October 27, 1997 the Company announced in a press release that they would take a charge of between $47 to $53 million in the third quarter due to accounting irregularities.
(10) March 27, 2002, during the conference call for the 2001 results, an analyst asks the CFO about off-balance sheet loans made to the Rigas family, but the CFO is unable to answer.
(11) March 20, 2000, the Company announced that they would restate earnings.
(12) July 7 1999, the Company substantially reduced their earnings expectations as a result of prior material misrepresentations to analysts and the investing community.
(13) April 15, 1998 the Company announced accounting problems.
(14) July 27, 2001 investors file a lawsuit against the Company alleging false and misleading statements.
(15) April 30, 2002, first class action complaint was filed alleging accounting fraud by WorldCom and CEO resigns. Additionally, since the price 7 days after the announcement was made was unavailable, a stock price of zero was used, as the Company filed for bankruptcy shortly after the announcement (July 21 2002). See chart below for more detail.
(16) October 12, 2001 the Company announced that it made a US $638 million loss during the third quarter of the fiscal year 2001.
(17) January 14, 2002, investors and analysts express concerns about accounting disclosures in the wake of Enron. The Company did not launch an investigation into the executive loans until June 6, 2002, after the CEO's indictment for tax evasion. Since the stock dropped substantially due to accounting concerns before the investigation, the January 14, 2002 date is used. Additionally, the 7 days subsequent to the announcement of the results of the internal probe will be used as the "7 day Price After Announcement."
(18) May 6, 2002, the Company announced a restatement.
(19) April 28, 1999, the Company issues a press release stating that they will need to restate results.
(20) April 3, 1998 the Company issued a press release stating that they would miss first quarter earnings
(21) September 20, 2004, Office of Federal Housing Enterprise Oversight issues report on Fannie's accounting.
(22) February 14, 2005, AIG discloses SEC subpoenas related to accounting practices.
(23) January 29, 2002, Wall Street Journal article runs on Elan's manipulative accounting practices.
(24) April 3, 2002 the Wall Street Journal runs article about Company's use of SPE's.
(25) March 15, 2004 Company announces internal investigation and suspension of top executives until outcome of audit.
(26) April 2, 2002, the Company discloses channel stuffing in its 2001 10-K filing.
(27) June 7, 2002, Company announces SEC investigation into "round-trip" transactions.
(28) June 16 2000, Xerox fires several executives at the company's Mexican offices for alleged accounting fraud. Falsely claims incident is isolated.
(29) February 4, 2001, Barron's runs an article questioning the Company's accounting.
(30) December 21, 2001, the Company announces internal probe and SEC investigation. The stock was halted for 9 days after the SEC investigation was announced. Therefore, the 7 days proceeding the stock halt were used as the 7 days after announcement..

Shareholder losses based on date of last unquestioned SEC filing

Table E2 examines the decline in total market capitalization for the period beginning on the date of the last unquestioned SEC filing through the period of resolution. The date of the last unquestioned filing is the date of the quarterly or annual filing immediately preceding the announcement of a problem. The resolution date is that date when investors received information resolving uncertainty about the accounting issue. Often the registrants filed amendments to restate their previously issued financial statements. In other instances, the registrants made public announcements indicating that they would restate, including quantitative information about the restatement. The time period corresponds to the interval beginning on the date when information based on original financial statements is most likely to be incorporated in market prices. This time period is likely to capture the economic effect of the market's reaction to the restatement event. It may, however, also capture the effect of other factors that may be indirectly related to or unrelated to the restatement. For example, the resignation of a CFO, director or auditor may occur or a lawsuit may be filed during this time period. Results indicate that over the long-term, accounting problems substantially impact stock prices.

Table E2: Market Cap Declines from Date of Last Unquestioned Filing Date Prior to Disclosure through Resolution

Company Name	Ticker	Last Unquestioned Filing Date	Resolution Date	Lost Market Cap ($ in millions)	Cumulative Return
Global Crossing (1)	GX	5/15/01	bankrupt	(11,689.7)	-100%
Krispy Kreme (2)	KKD	4/16/04	Not yet resolved	(1,642.6)	-81%
Critical Path (1)	CPTH	11/14/00	bankrupt	(2,710.9)	-100%
Network Associates	MFE	11/14/00	12/26/00	(335.5)	-13%
Rite Aid	RAD	7/13/99	10/11/00	(5,550.3)	-88%
Lernout & Hauspie (1)	LHSP	3/31/00	bankrupt	(5,183.3)	-100%
Symbol Technologies (1)	SBL	11/2/01	bankrupt	(3,001.0)	-100%
Health South (2)	HLSH	8/14/02	not yet resolved	(2,584.5)	-57%
Oxford Health Plans	OHP	8/5/97	4/3/98	(5,057.5)	-79%
Adelphia (1)	ADELQ	11/15/01	bankrupt	(3,933.6)	-100%
MicroStrategy	MSTR	1/28/00	6/22/01	(11,859.4)	-98%
Waste Management	WMI	5/14/99	12/20/99	(24,418.2)	-73%
Cendant	CD	3/31/98	10/13/98	(24,442.7)	-73%
Qwest	Q	5/15/01	11/18/04	(55,685.0)	-89%
WorldCom (1)	WCOM	3/13/02	bankrupt	(19,969.5)	-100%
Enron (1)	ENE	8/14/01	bankrupt	(32,090.2)	-100%
Tyco	TYC	12/28/01	12/31/02	(80,857.6)	-70%
Peregrine Systems (1)	PRGN	11/4/01	bankrupt	(3,253.4)	-100%
McKesson HBOC	MCK	4/22/99	7/14/99	(9,097.5)	-51%
Sunbeam (1)	SOC	1/29/98	bankrupt	(3,079.1)	-100%
Fannie Mae (2)	FNM	8/8/03	Not yet resolved	(12,310.5)	-19%
AIG (2)	AIG	8/9/04	Not yet resolved	(38,708.5)	-22%
Elan	ELN	1/23/02	9/4/03	(11,631.4)	-85%
Dynegy	DYN	3/13/02	4/11/03	(3,995.7)	-91%
Nortel	NT	12/23/03	1/11/05	(523.2)	-16%
Bristol-Myers Squibb	BMY	11/15/01	3/15/03	(64,515.3)	-61%
El Paso	EP	5/10/02	4/30/03	(10,339.1)	-78%
Xerox	XRX	6/7/00	7/1/02	(11,223.6)	-65%
Purchase Pro (1)	PROEQ.PK	1/2/01	bankrupt	(5,075.0)	-100%
Homestore	HOMS	8/14/01	3/12/02	(2,338.2)	-94%
	TOTAL			(467,102.1)	-123%

Source: GLC, Capital IQ, and BigCharts.com Note: Company's in the above table were selected based on the large market capitalization changes associated with their accounting announcements. The data is not adjusted for other market changes occurring during the respective time periods affecting each firm.
(1) In instances where a company declared bankruptcy, the stock price at the resolution date is assumed to be zero.
(2) The resolution date reflects the closing stock price on May 17, 2005, as the accounting issues have not yet been resolved

Shareholder losses based on all time stock high and low during the period in which fraud occurred

Table E3 examines the decline in total market capitalization for the period beginning on the date of the stock all-time high and low, during the period in which the fraudulent activity allegedly occurred. This time period is likely to capture the total market capitalization losses that occurred as a result of manipulated earnings, which tend to propel stock prices during the period of fraudulent accounting activity. It may, however, also capture the effect of other market factors, such as the "Internet Bubble" that may be indirectly related to or unrelated to the restatement. Results indicate that fraudulent accounting can substantially impact stock prices.

Table E3: Market Cap Declines from Date of Highest and Lowest Close During Period that Fraud Allegedly Occurred

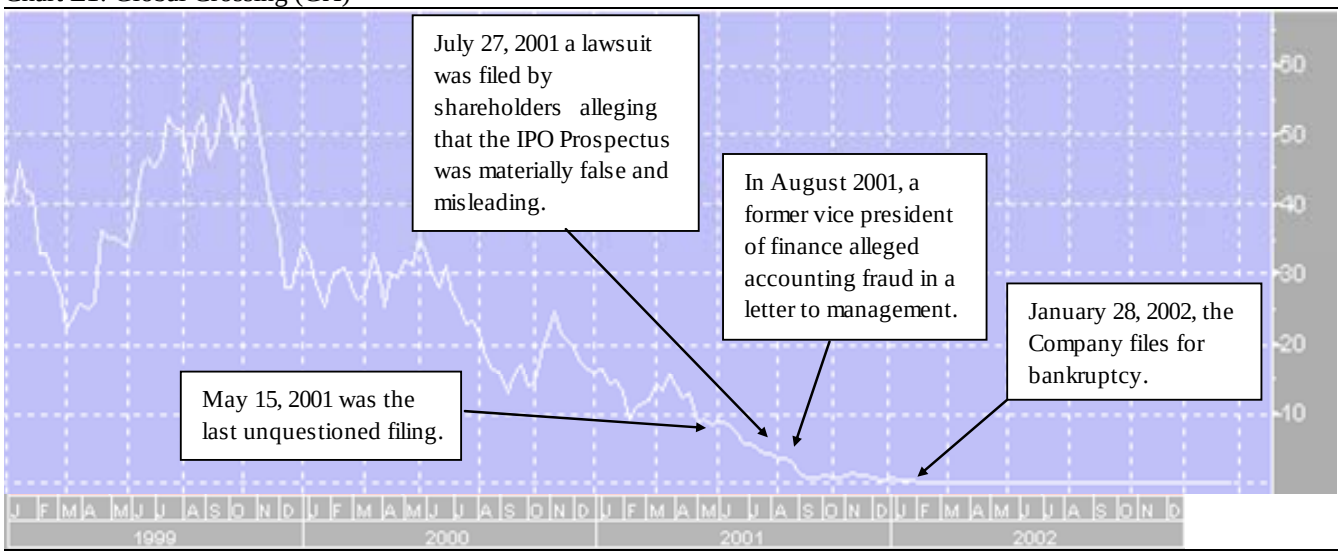
Company Name	Ticker	Stock Price Peak Date	Price of Stock at Peak	Stock Price Bottom Date	Price of Stock at Bottom	Lost Market Cap ($ in millions)	Cumulative Return
Global Crossing	GX	5/19/99	$58.25	01/28/02	$0.00	(25,356)	-100.0%
Krispy Kreme	KKD	8/18/03	$49.37	02/24/05	$5.36	(2,578)	-88.7%
Critical Path	CPTH	8/31/00	$309.00	11/09/04	$0.00	(4,907)	-100.0%
Network Associates	MFE	12/24/98	$66.00	12/28/00	$4.13	(8,301)	-93.6%
Rite Aid	RAD	1/8/99	$50.94	10/31/02	$1.79	(12,258)	-93.0%
Lernout & Hauspie	LHSP	3/14/00	$65.00	11/29/00	$0.00	(6,098)	-100.0%
Symbol Technologies	SBL	3/5/01	$34.47	10/10/02	$4.99	(4,001)	-77.7%
Health South	HLSH	8/29/01	$18.26	03/31/03	$0.07	(7,117)	-99.6%
Oxford Health Plans	OHP	8/4/97	$85.81	08/13/98	$6.63	(6,185)	-92.1%
Adelphia	ADELQ	1/4/01	$50.31	06/25/02	$0.00	(7,699)	-100.0%
MicroStrategy	MSTR	3/14/00	$2,920.00	07/26/02	$4.50	(22,803)	-99.8%
Waste Management	WMI	5/4/99	$59.00	03/28/00	$13.06	(27,661)	-77.4%
Cendant	CD	3/24/98	$41.00	10/08/98	$7.50	(27,717)	-81.3%
Qwest	Q	7/5/00	$58.00	08/13/02	$1.11	(48,942)	-96.3%
WorldCom	WCOM	6/30/99	$61.93	07/21/02	$0.00	(119,874)	-100.0%
Enron	ENE	8/23/00	$90.00	12/02/01	$0.00	(66,501)	-100.0%
Tyco	TYC	1/30/01	$62.80	07/25/02	$8.25	(93,312)	-85.0%
Peregrine Systems	PRGN	3/27/00	$79.50	09/22/02	$0.00	(8,350)	-100.0%
McKesson HBOC	MCK	10/6/98	$94.69	05/26/00	$16.06	(4,848)	-51.6%
Sunbeam	SOC	3/4/98	$52.00	10/25/01	$0.05	(4,442)	-99.9%
Fannie Mae	FNM	2/19/04	$79.88	04/04/05	$51.46	(27,675)	-35.7%
AIG	AIG	6/7/04	$74.80	04/29/05	$50.85	(62,653)	-32.1%
Elan	ELN	6/20/01	$62.87	10/09/02	$1.17	(20,187)	-98.0%
Dynegy	DYN	5/1/01	$57.95	07/25/02	$0.51	(18,700)	-99.0%
Nortel	NT	7/26/00	$83.88	10/10/02	$0.44	(67,157)	-99.5%
Bristol-Myers Squibb	BMY	12/29/00	$73.94	07/24/02	$20.55	(104,615)	-72.4%
El Paso	EP	2/21/01	$74.50	02/13/03	$3.45	(35,172)	-94.4%
Xerox	XRX	5/3/1999	$63.69	12/07/00	$4.44	(39,068)	-93.0%
Purchase Pro	PROE.Q	12/28/99	$395.94	09/13/02	$0.00	(12,353)	-100.0%
Homestore	HOMS	1/25/00	$122.25	02/11/02	$0.69	(8,500)	-99.1%
	TOTAL					(905,030)	-77.1%

Source: GLC, Capital IQ, and BigCharts.com Note: Company's in the above table were selected based on the large market capitalization changes associated with their accounting announcements. The data is not adjusted for other market changes occurring during the respective time periods affecting each firm.
(1) Converted in to USD from Euros.

Individual Stock Charts

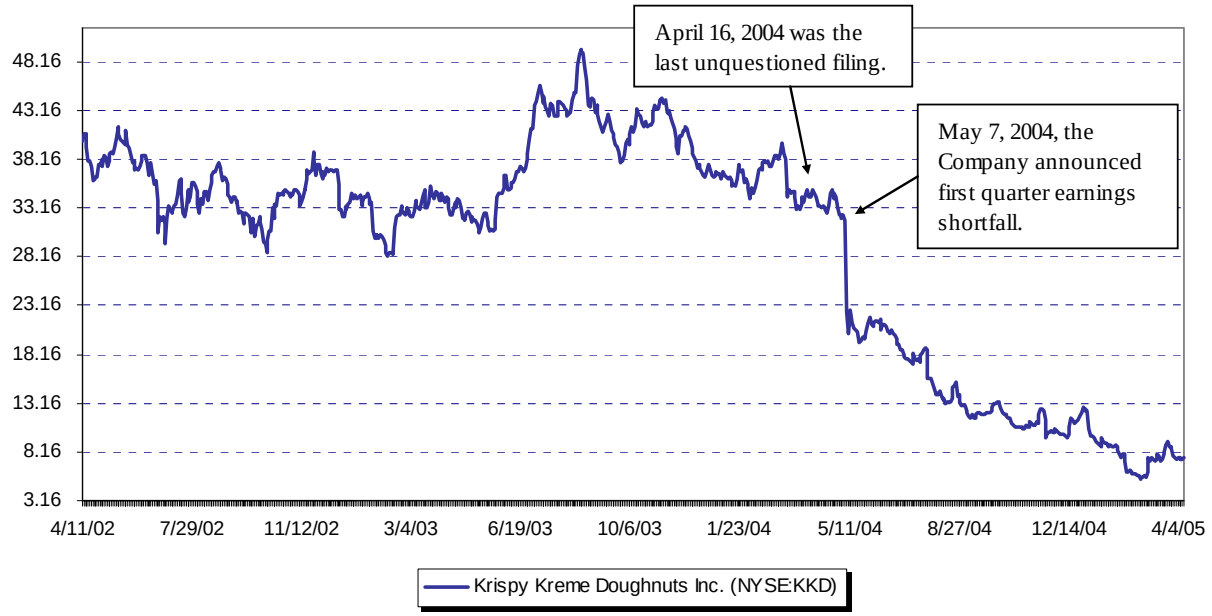
The following are individual stock charts for the companies in Table E1 and E2 above. These charts provide detail surrounding the events that lead to a price decline in the stock including, the last unquestioned filing date, company press releases and articles, and the resolution dates (i.e. date of the filing of the amended 10-K.)

Chart E1: Global Crossing (GX)



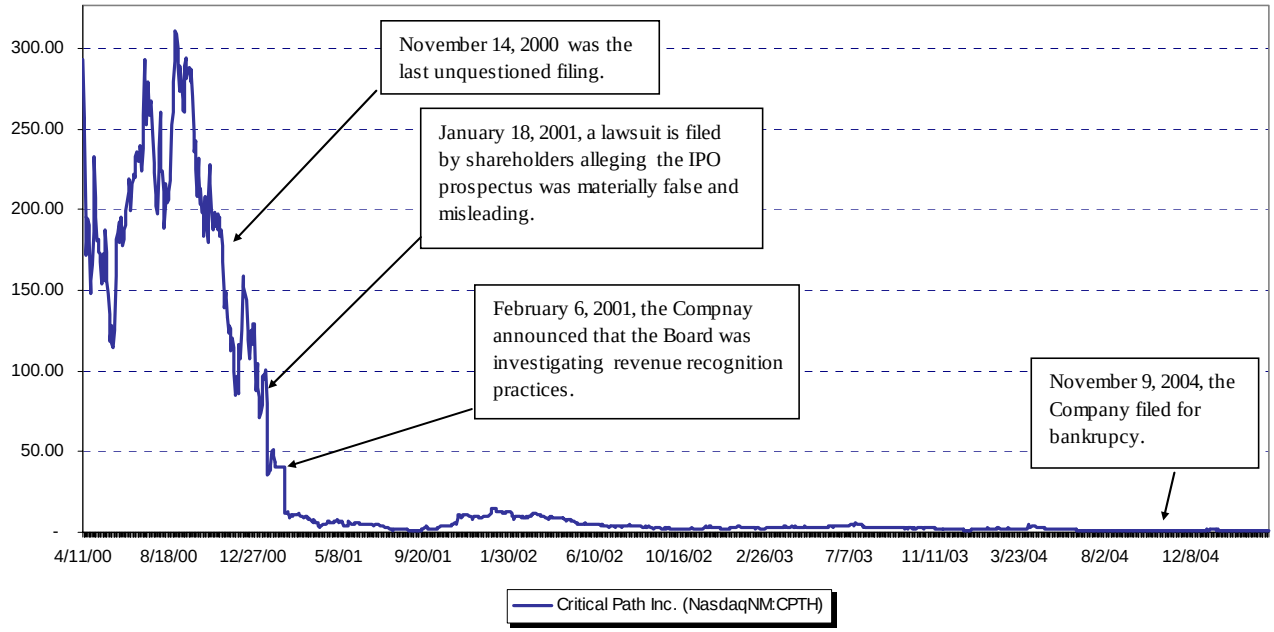
Source: Bloomberg.

Chart E2: Krispy Kreme Doughnuts (KKD)



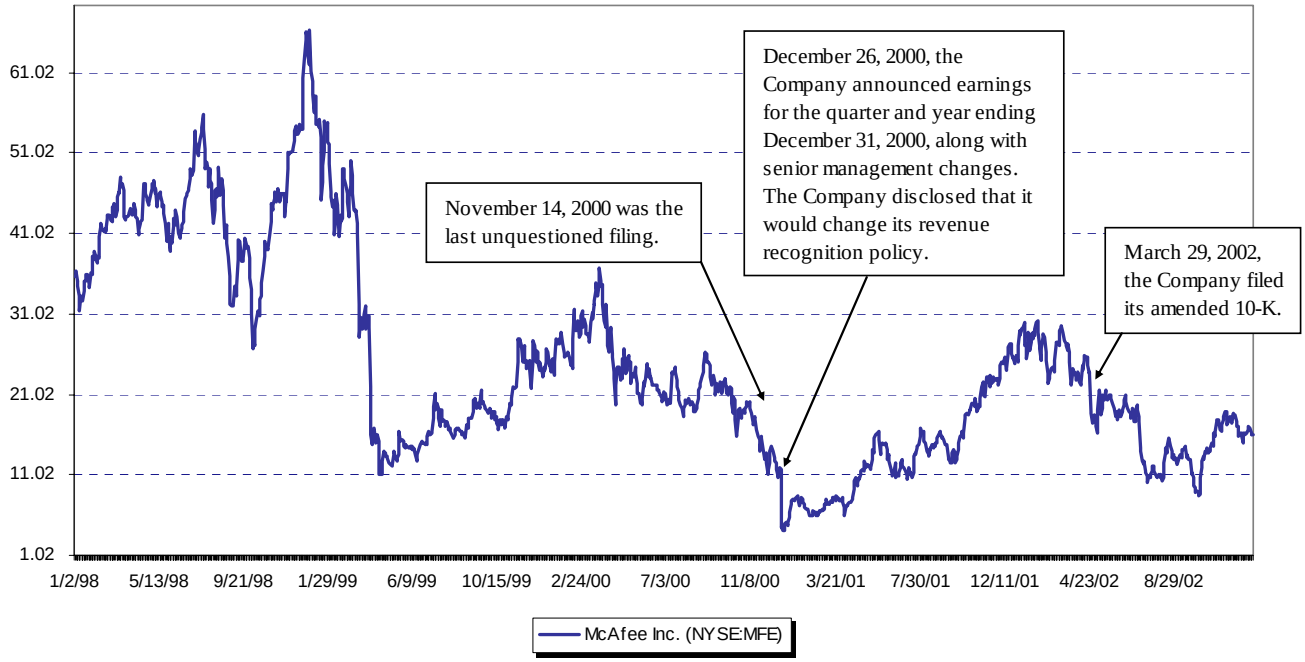
Source: GLC, Capital IQ.

Chart E3: Critical Path (CPTH)



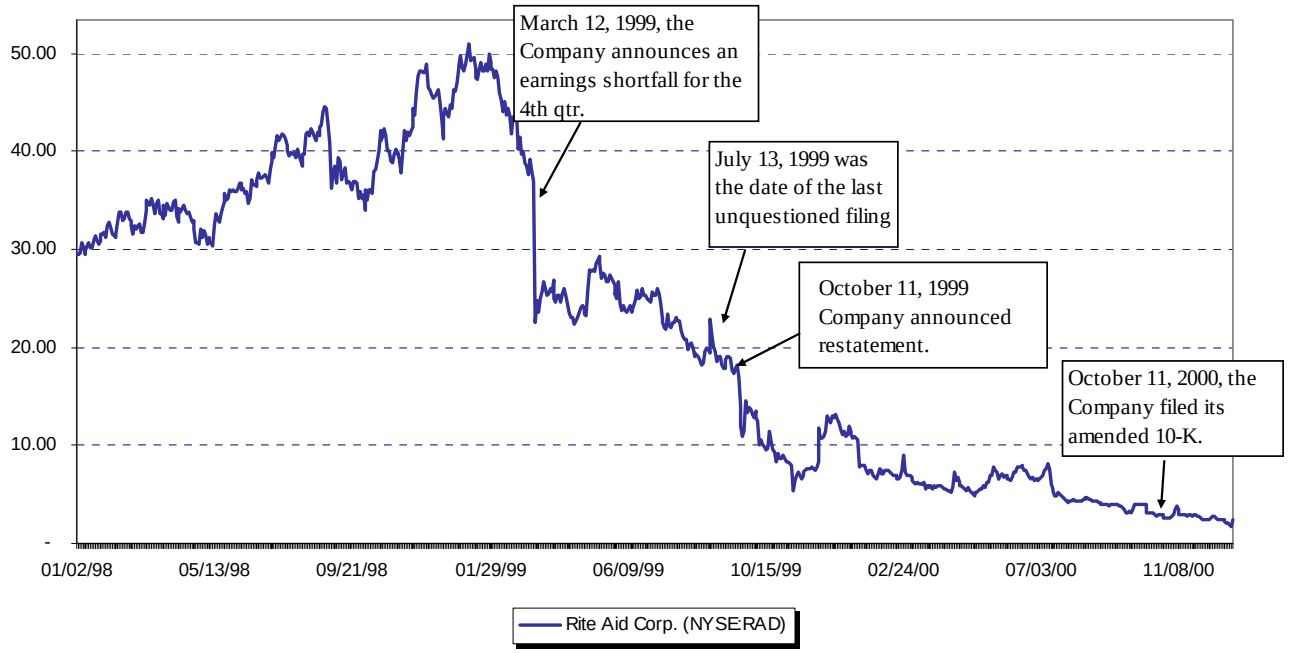
Source: GLC, Capital IQ.

Chart E4: Network Associates (Now McAfee) (MFE)



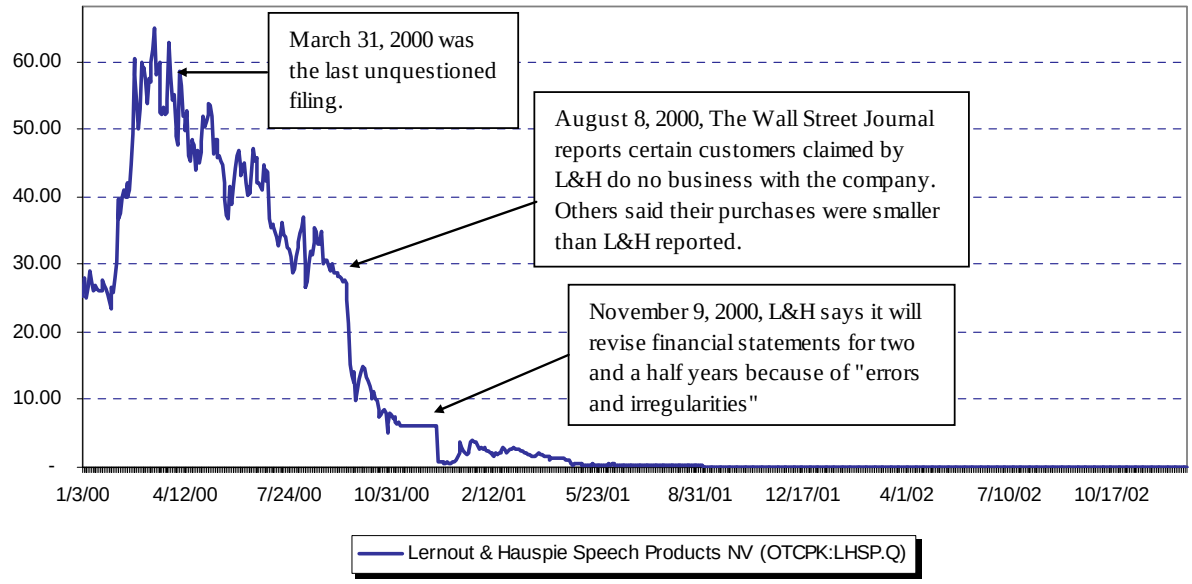
Source: GLC, Capital IQ.

Chart E5: Rite Aid (RAD)



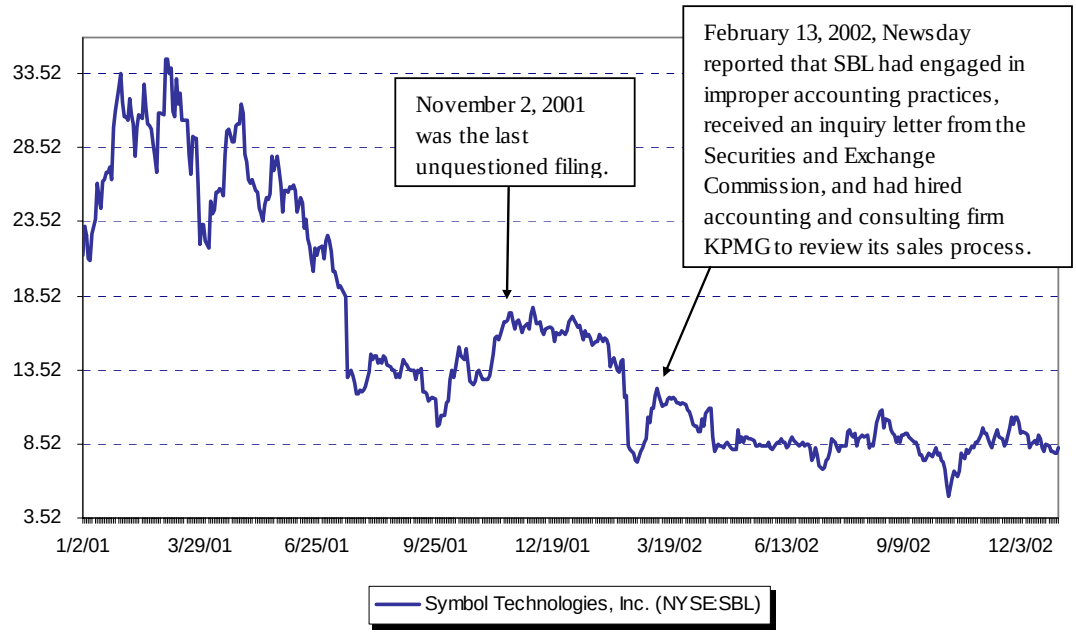
Source: GLC, Capital IQ.

Chart E6: Lernout & Hauspie (LHSP)



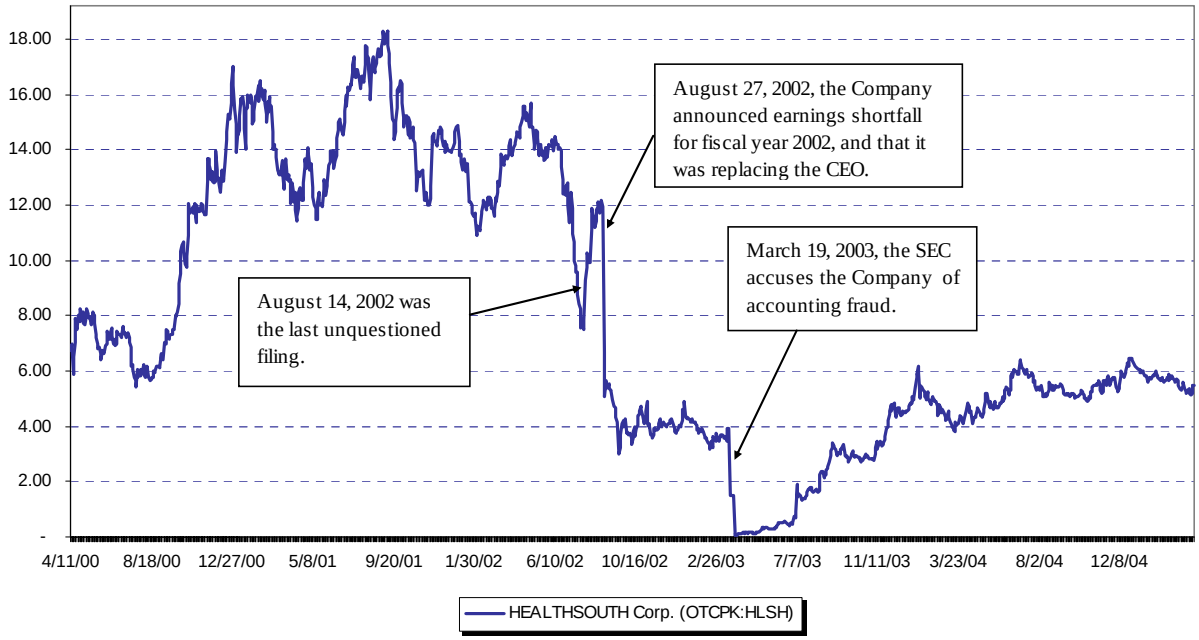
Source: GLC, Capital IQ.

Chart E7: Symbol Technologies (SBL)



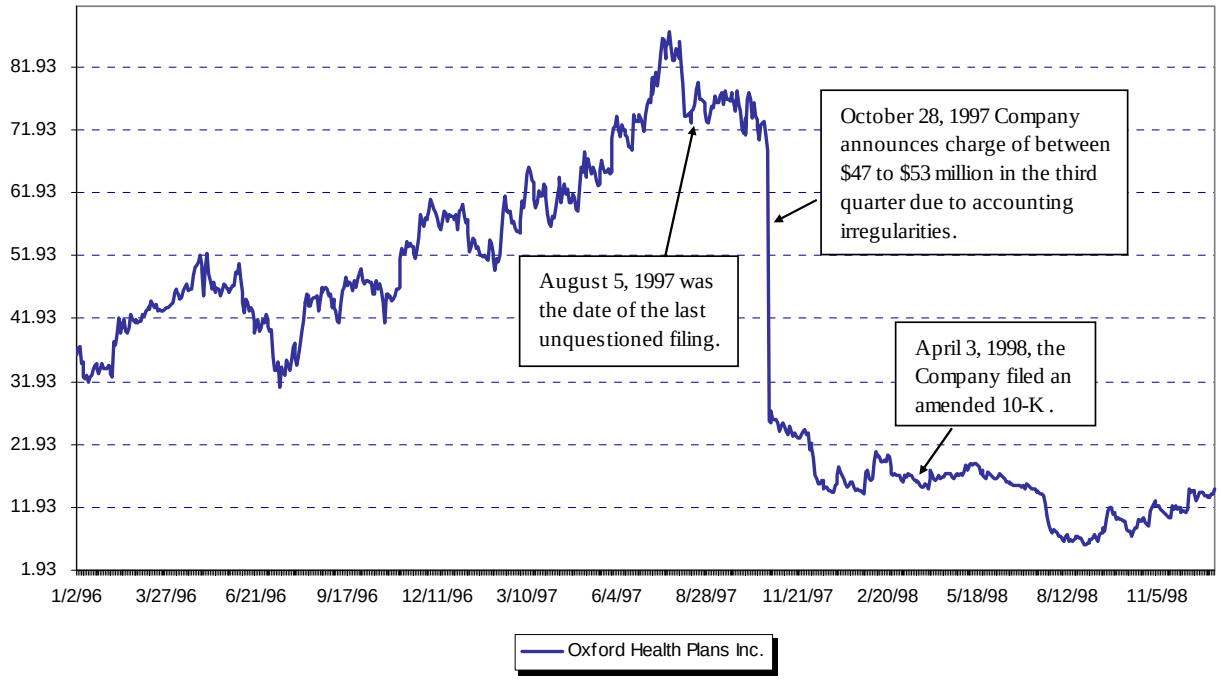
Source: GLC, Capital IQ.

Chart E8: Health South (HLSH)



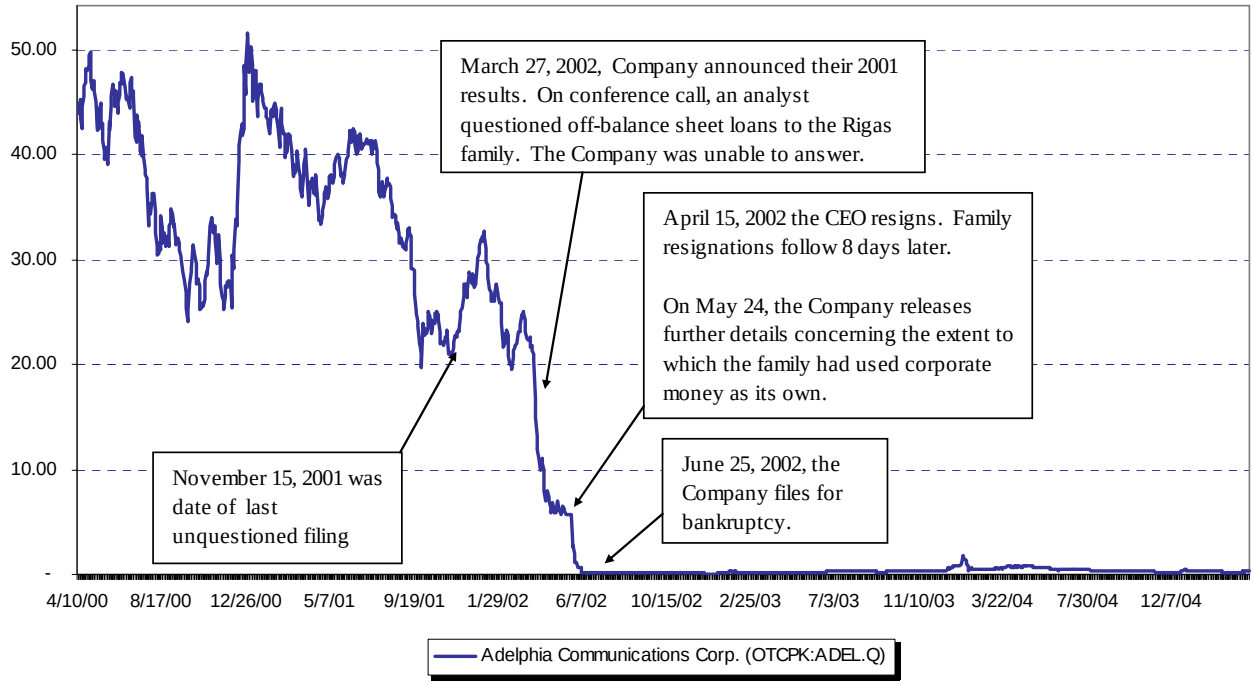
Source: GLC, Capital IQ.

Chart E9: Oxford Health Plans (OHP)



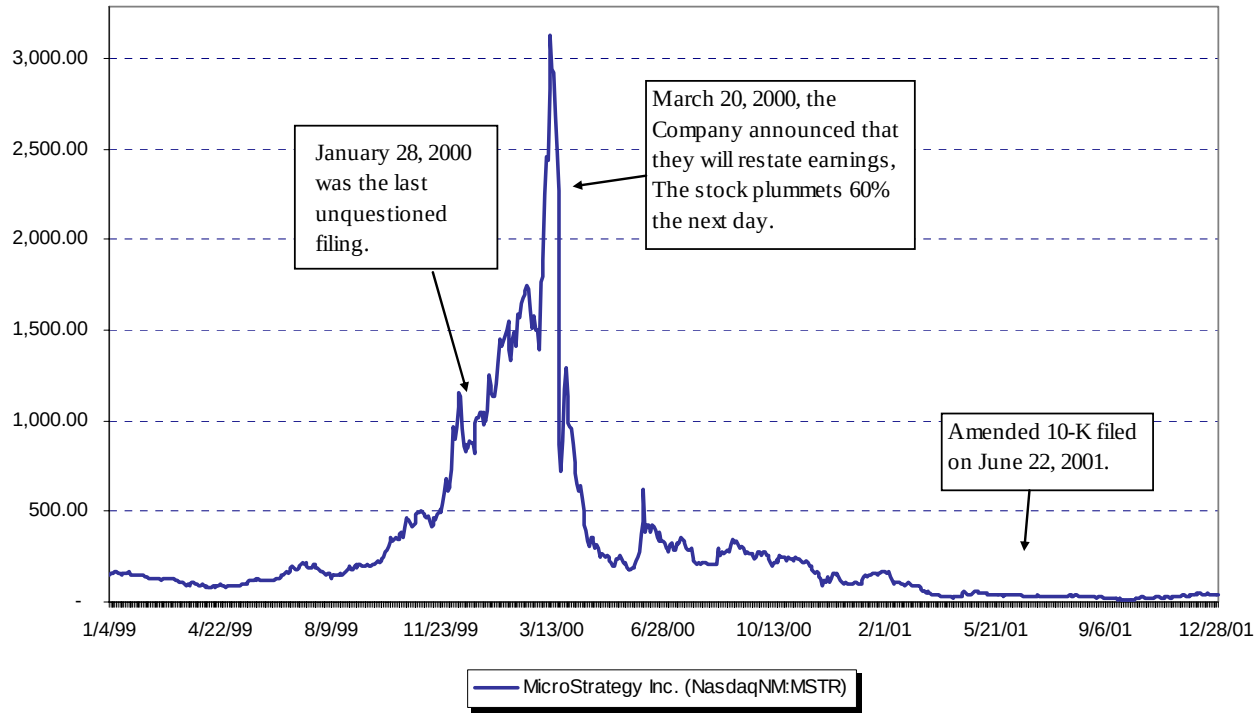
Source: GLC, Capital IQ.

Chart E10: Adelphia (ADEL)



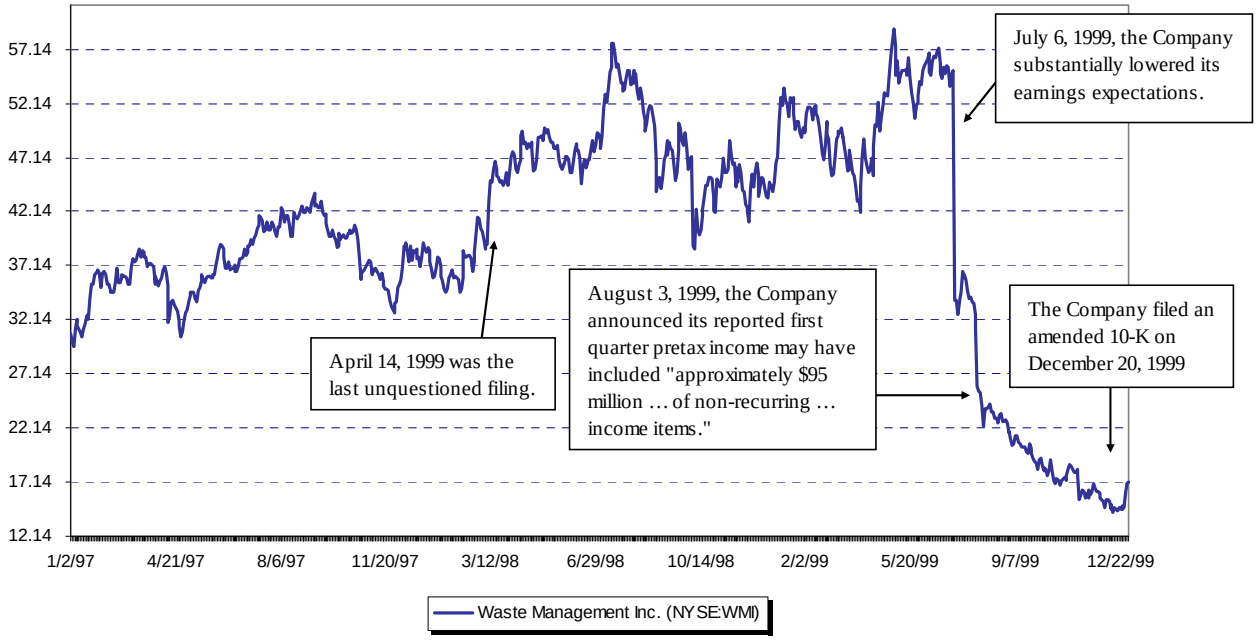
Source: GLC, Capital IQ.

Chart E11: MicroStrategy (MSTR)



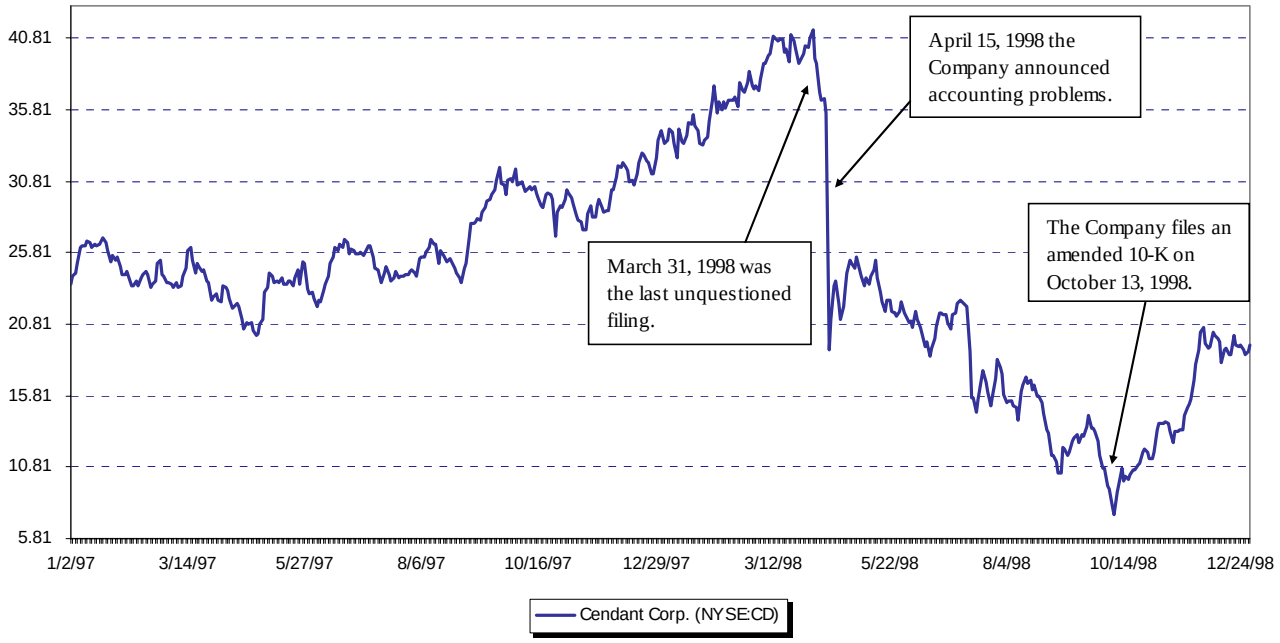
Source: GLC, Capital IQ.

Chart E12: Waste Management (WMI)



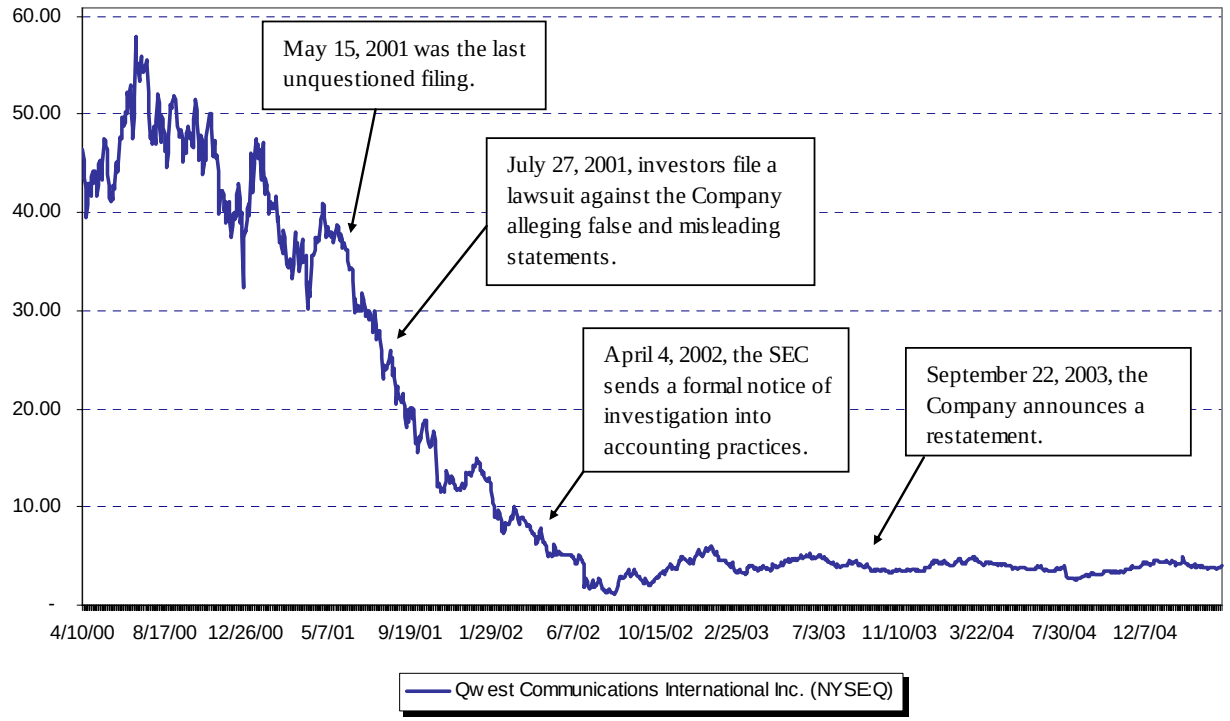
Source: GLC, Capital IQ.

Chart E13: Cendant (CD)



Source: GLC, Capital IQ.

Chart E14: Qwest (Q)

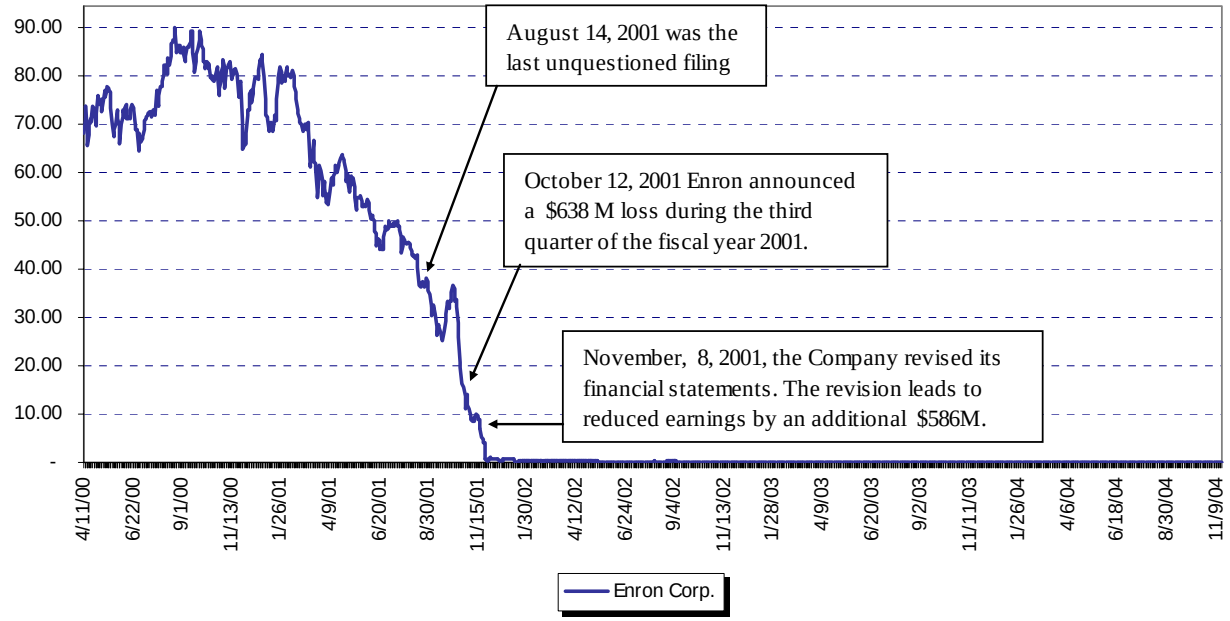


Source: GLC, Capital IQ.

Chart E15: WorldCom (WCOM)

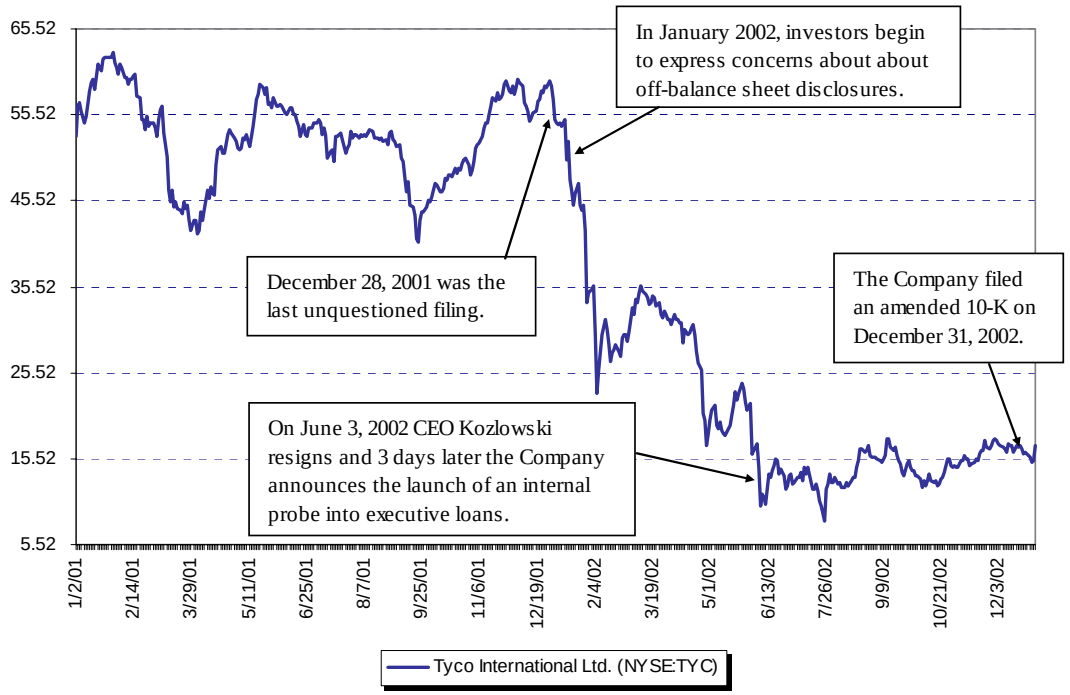
Source: BigCharts.com.

Chart E16: Enron (ENE)



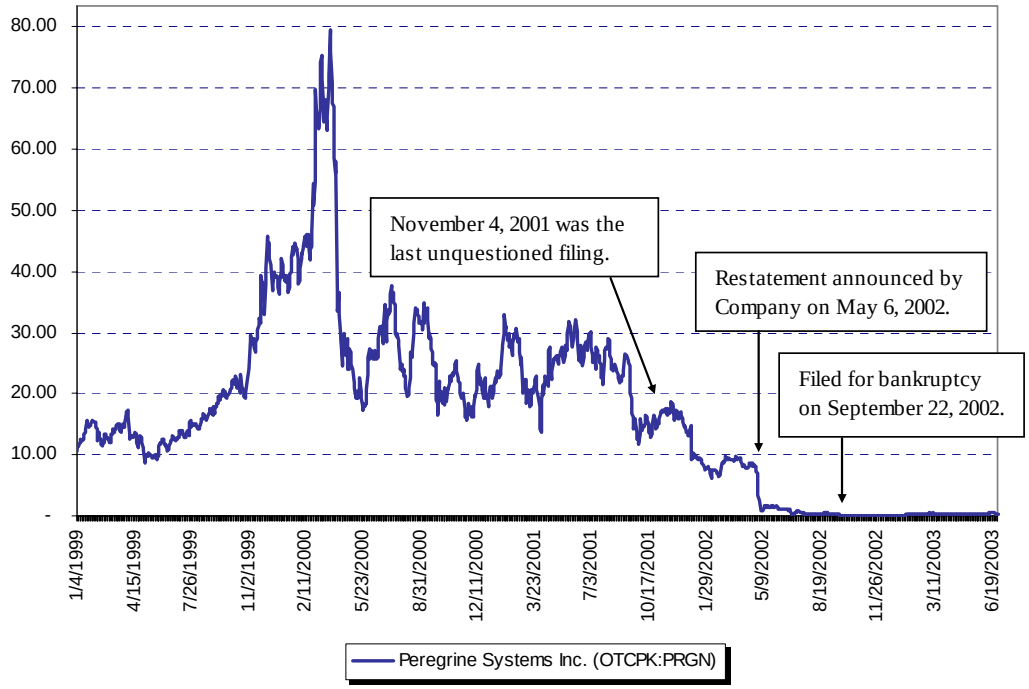
Source: GLC, Capital IQ.

Chart E17: Tyco (TYC)



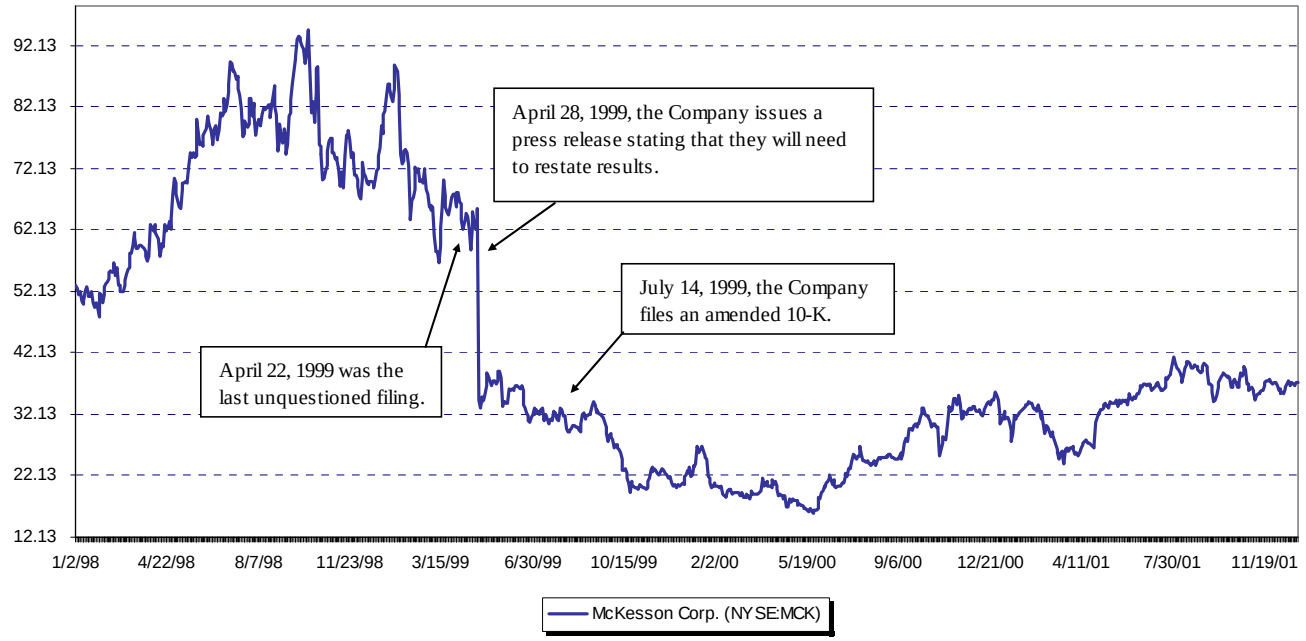
Source: GLC, Capital IQ, Wall Street Journal.

Chart E18: Peregrine Systems (PRGN)



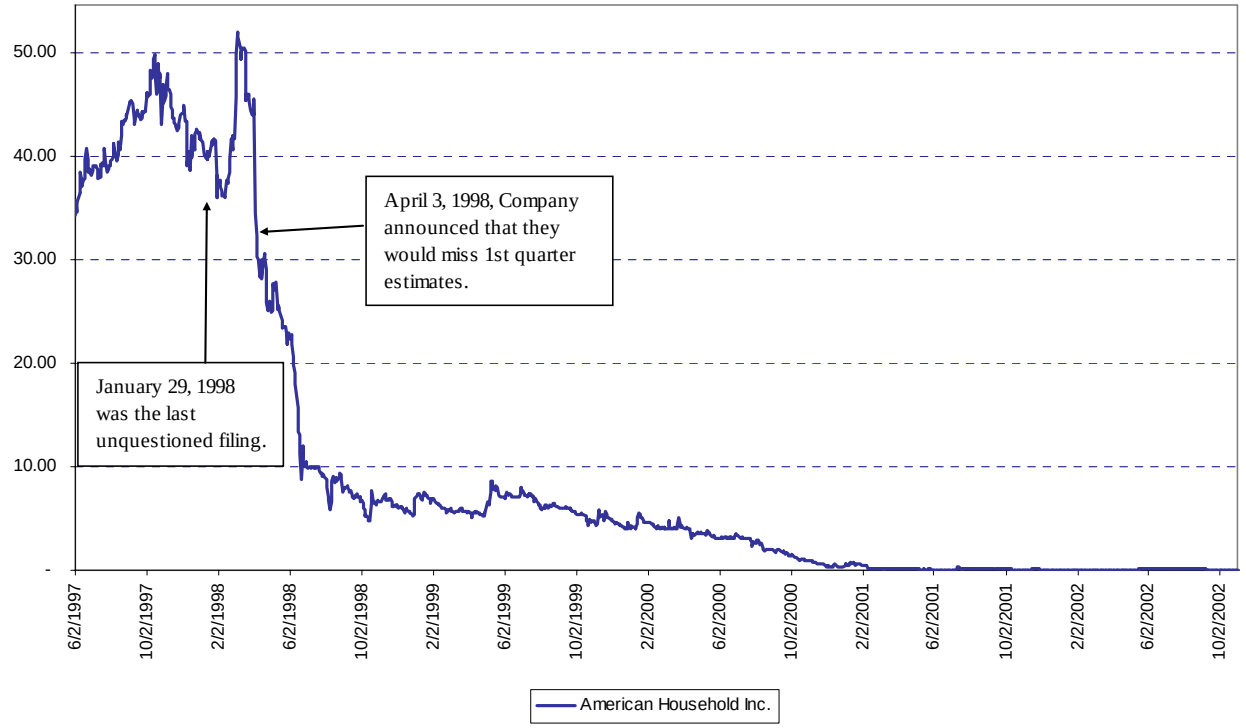
Source: GLC, Capital IQ.

Chart E19: McKesson HBOC (MCK)



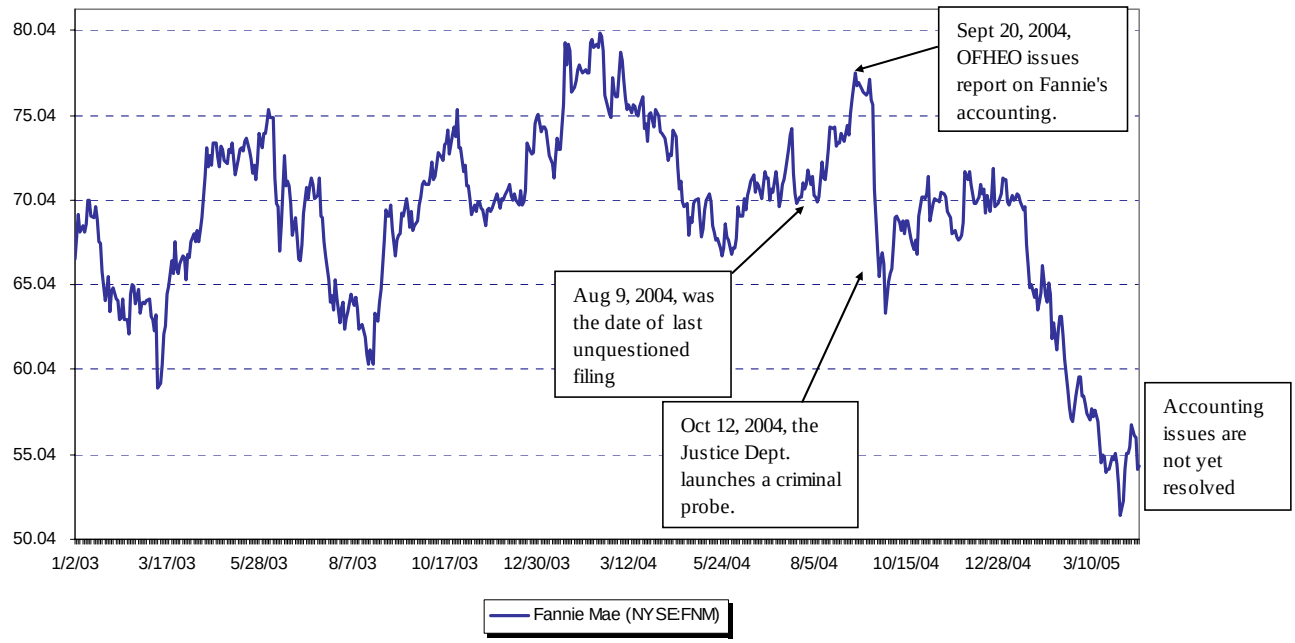
Source: GLC, Capital IQ.

Chart E20: Sunbeam (SOC) (Now American Household)



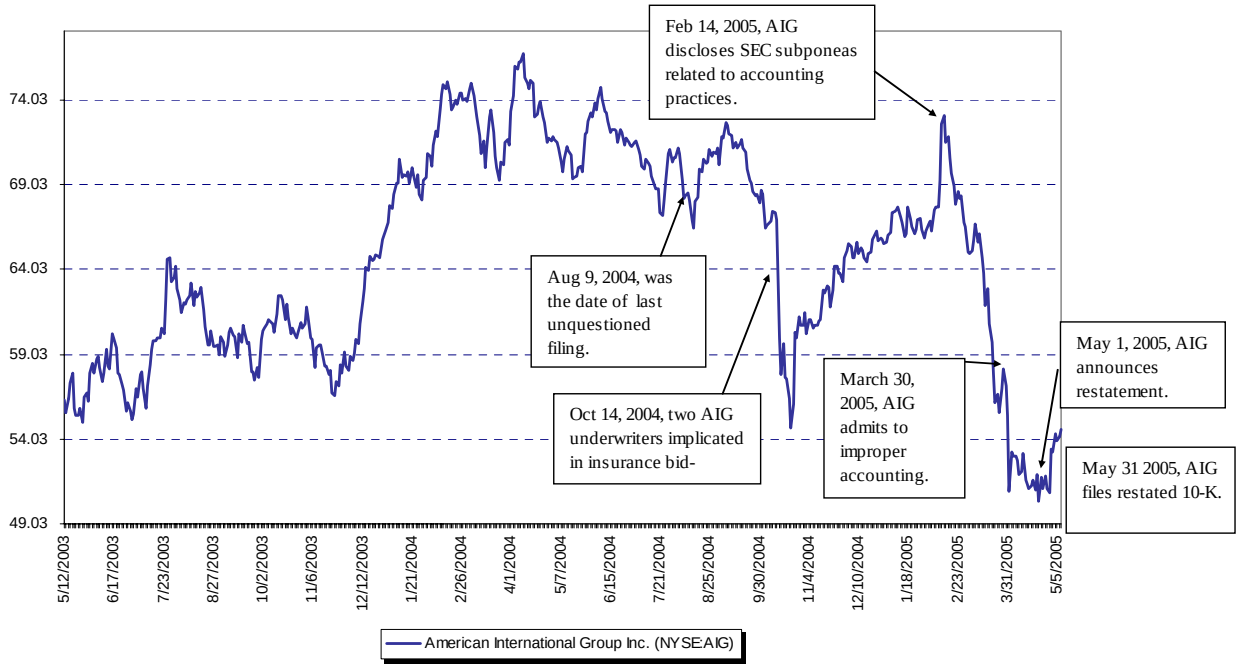
Source: GLC, Capital IQ.

Chart E21: Fannie Mae (FNM)



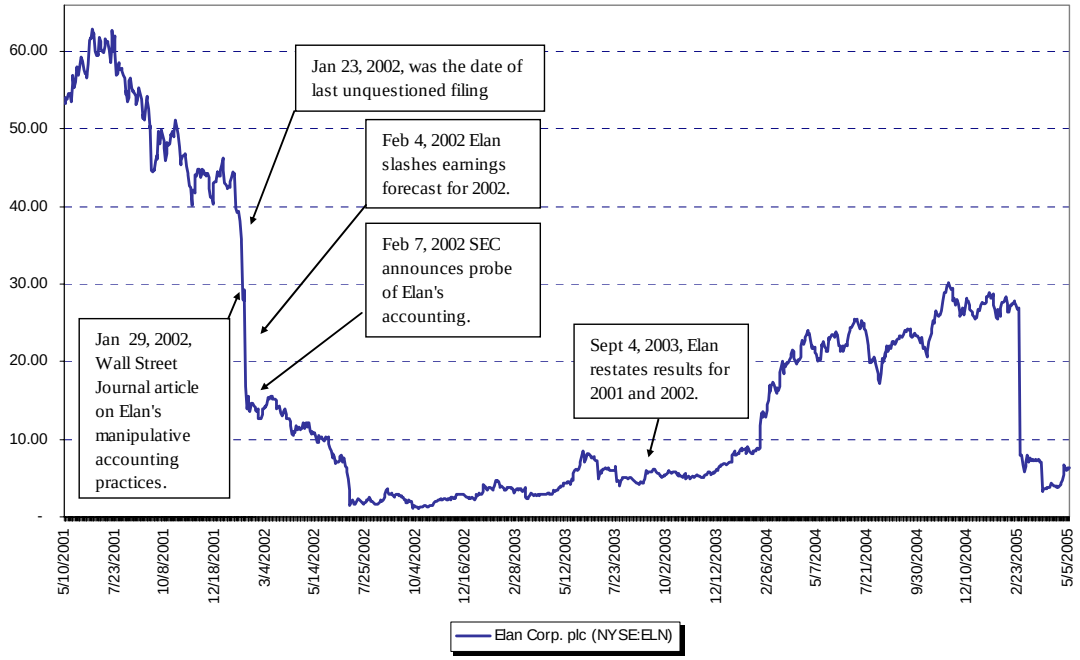
Source: GLC, Capital IQ.

Chart E22: American International Group (AIG)



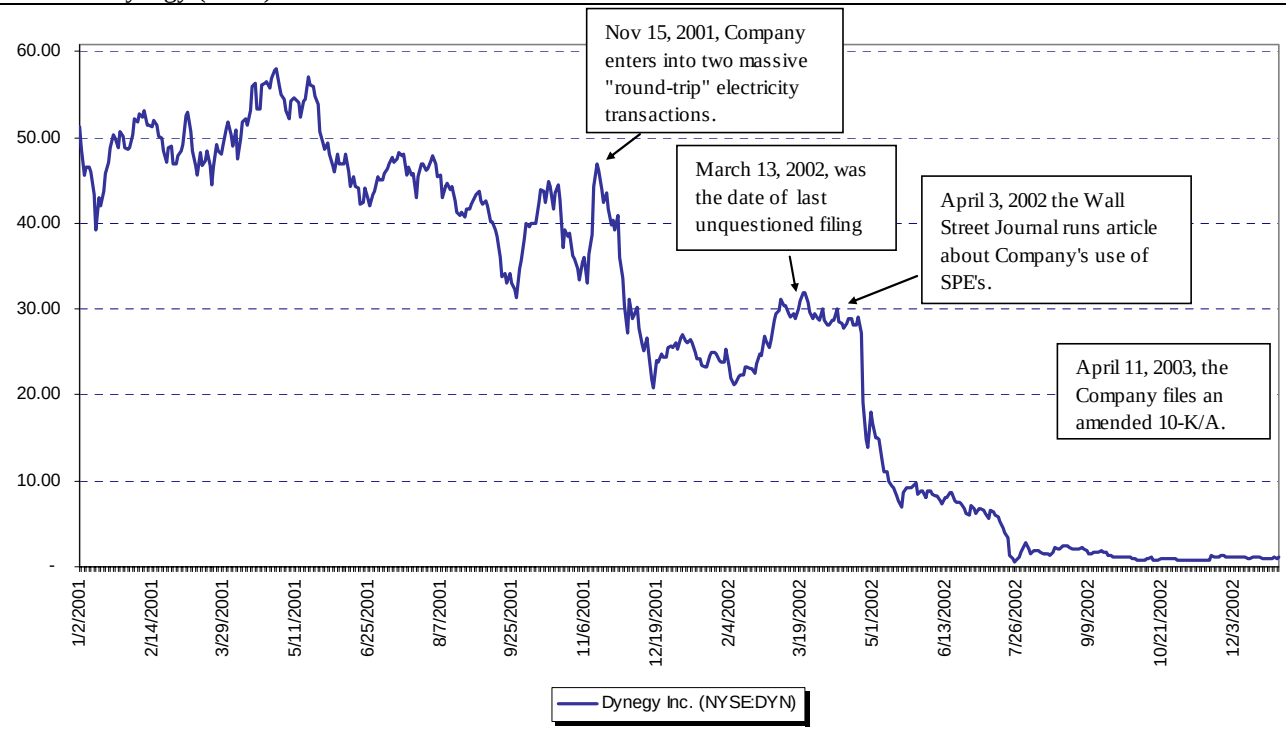
Source: GLC, Capital IQ.

Chart E23: Elan Corp (ELAN)



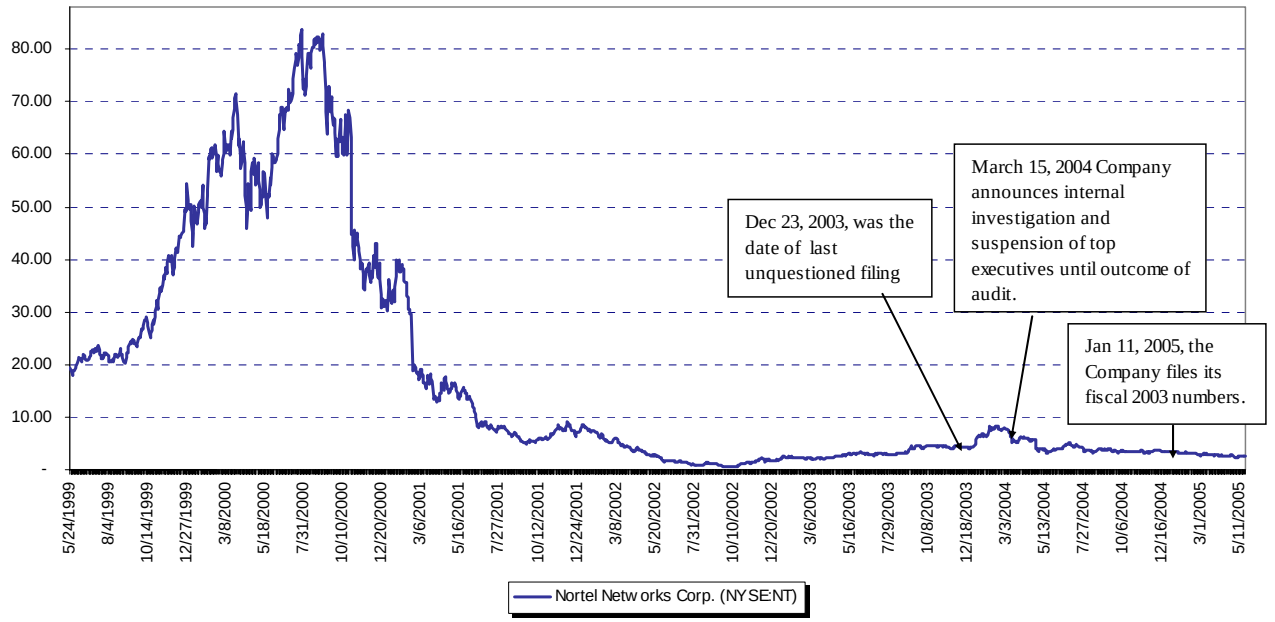
Source: GLC, Capital IQ.

Chart E24: Dynegy (DYN)



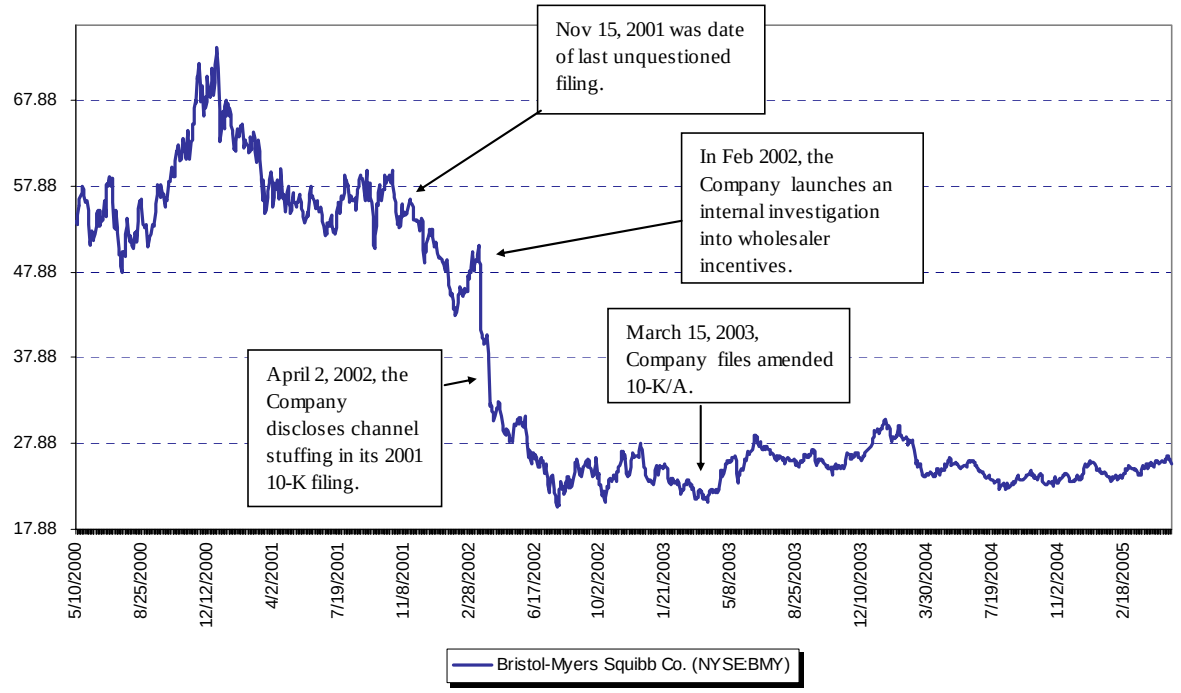
Source: GLC, Capital IQ.

Chart E25: Nortel Networks (NT)



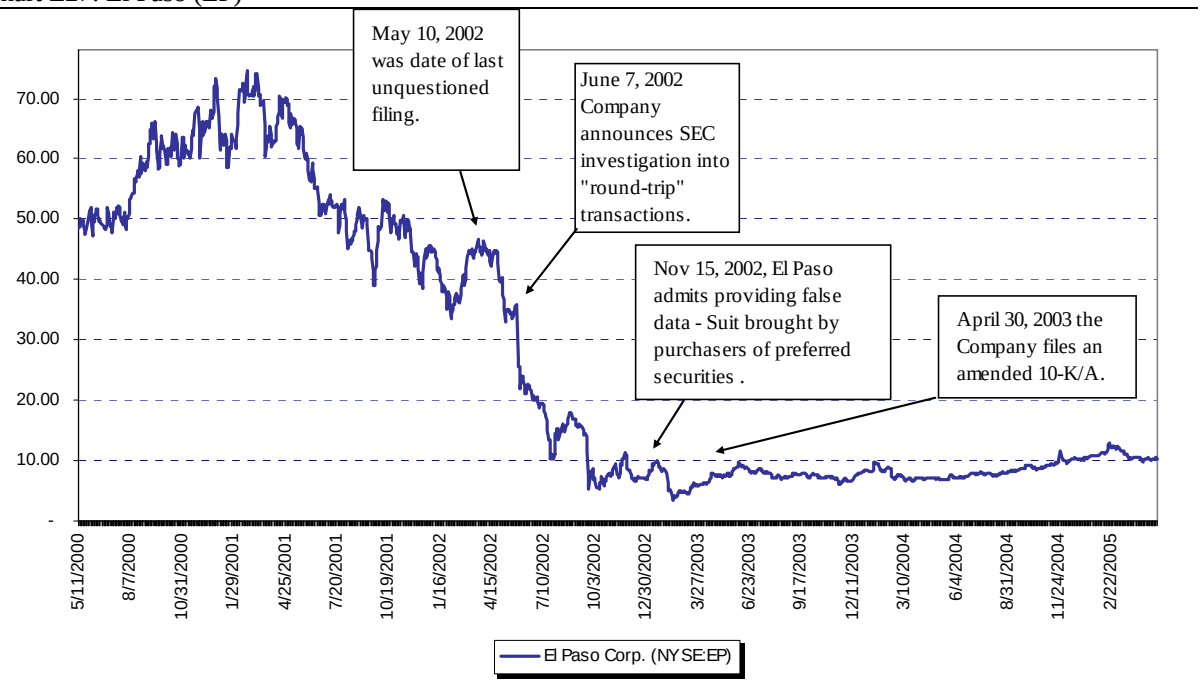
Source: GLC, Capital IQ.

Chart E26: Bristol Myers Squibb (BMY)



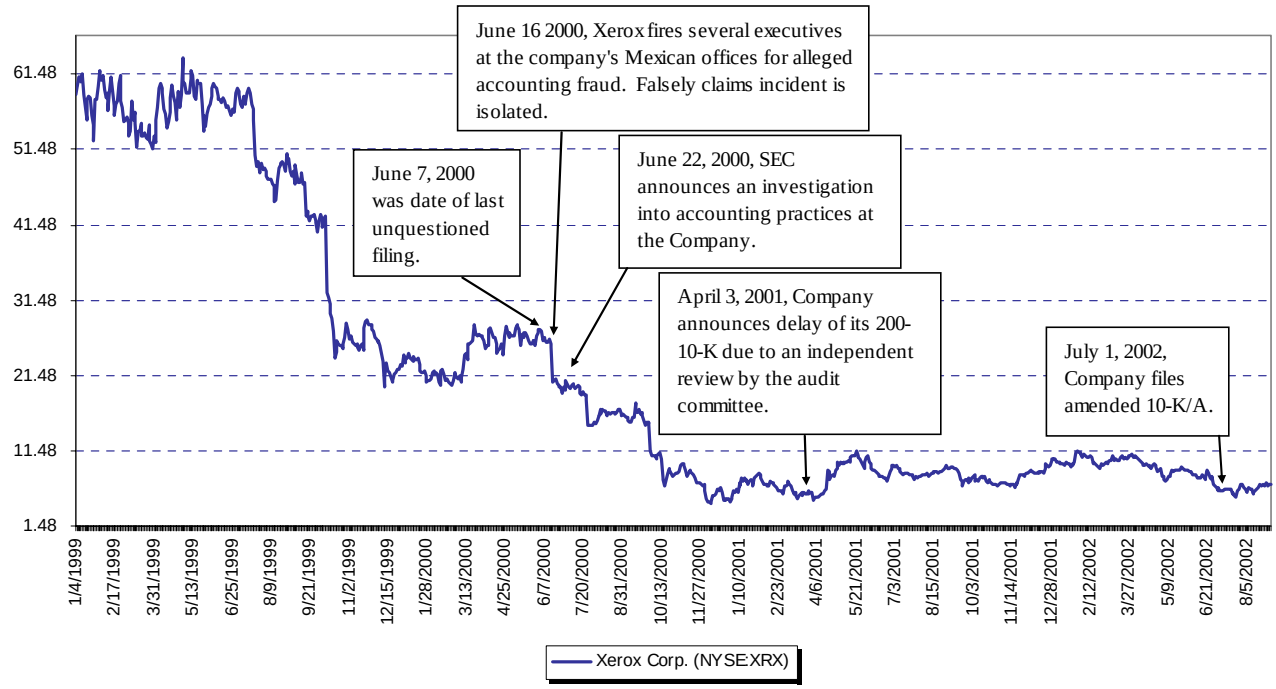
Source: GLC, Capital IQ.

Chart E27: El Paso (EP)



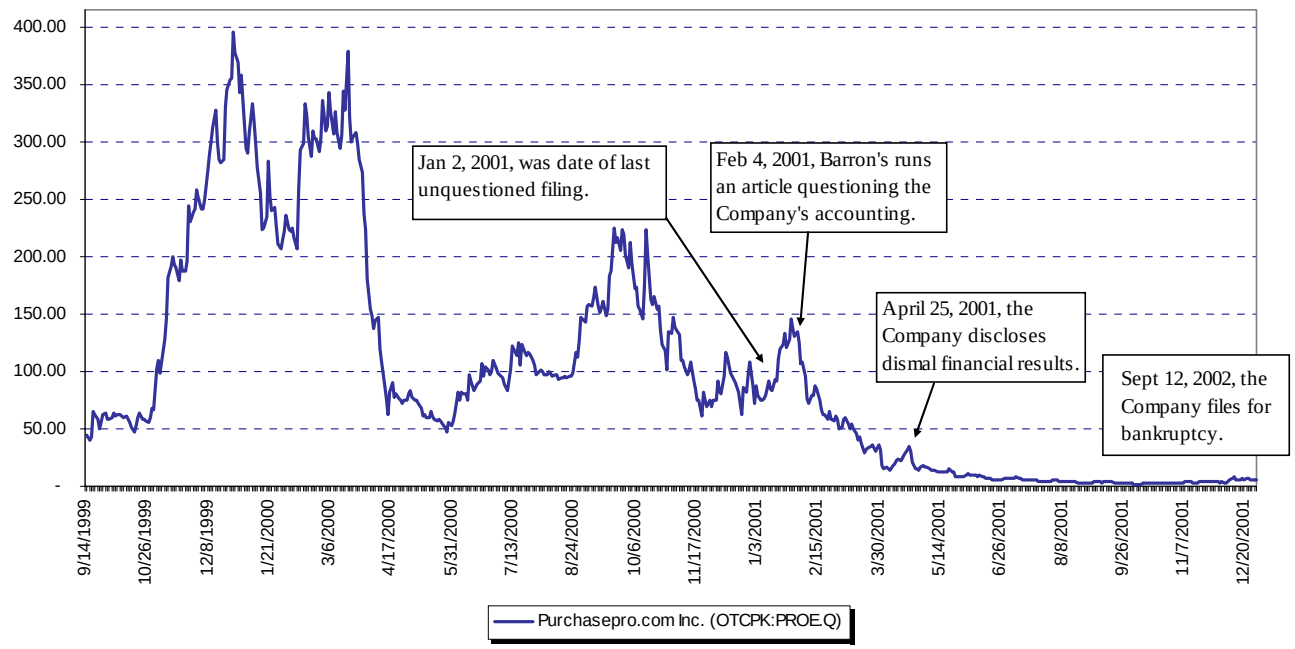
Source: GLC, Capital IQ.

Chart E28: Xerox (XRX)



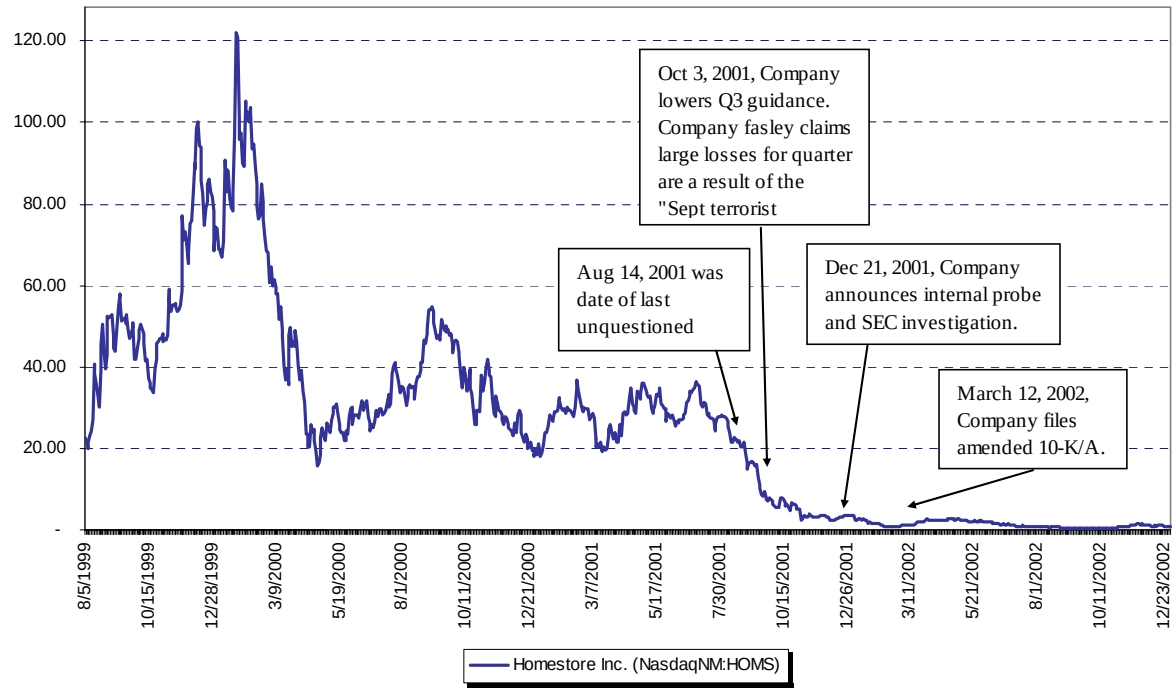
Source: GLC, Capital IQ.

Chart E29: Purchase Pro (PRO)



Source: GLC, Capital IQ.

Chart E30: HomeStore (HOMS)



Source: GLC, Capital IQ.

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GLASS LEWIS & Co.

TREND ALERT

Restatements – Traversing Shaky Ground

An Analysis for Investors

In the investment world, financial restatements can be earthquakes. The initial impact can rock a company's share price. Aftershocks, arising as the nature of the restatement surfaces, can do more financial damage. Investors must survive both. A good first step to help investors avoid, or at least decrease, the financial damage is to identify indicators that heighten the risk of restatement, specifically any signs that point to a company being likely to cook the books. Equally important, when a restatement is announced, investors must figure out its likely impact on share price. Is it a catastrophic 9.0 on the Richter scale or a jittery 3.5? This report equips investors with the information necessary to identify restatement indicators and to deal effectively with post-announcement tremors. We present a detailed analysis of 2003 and 2004 restatements, including the primary causes, relevant trends and key questions investors should ask when a restatement is announced.

Key Findings

- The number of restatements filed by U.S. domiciled publicly traded companies[1] to correct accounting errors increased 20% in 2004 over 2003, to 619 from 514 respectively.
- Restatements are also rising on a per capita basis. In 1997, one restatement was filed for every 100 U.S. domiciled public companies. By 2004, the rate increased to more than five restatements for every 100 U.S. domiciled public companies.
- The risk of restatement for public companies audited by small and mid-sized accounting firms is nearly three times as high as that for companies audited by the Big Four firms.
- In both 2003 and 2004, Deloitte & Touche had the highest average restatement rate (7%) and Ernst & Young the lowest (3%) among the Big Four accounting firms.
- The utility sector had the highest restatement rate in 2004 at 13%. The services sector was second highest at 8%. Within these sectors, natural gas, gaming and investment services companies were most prone to restate.
- Companies listed on the OTC exchanges restate at more than twice the rate as those listed on the NYSE. The 2004 restatement rates for companies listed on the NYSE, AMEX, NASDAQ and OTC were 3%, 5%, 5% and 7%, respectively.
- Smaller public companies restate twice as often as the largest public companies. Specifically, companies with annual revenues of less than $500 million had a 2004 restatement rate of 9%. Companies with revenues of more than $10 billion had a 2004 restatement rate of less than 4%. It is important to note, however, the market capitalization losses caused by a restatement for a single large company may well dwarf that of many small companies.
- Expense and revenue recognition errors were the most common issue leading to a restatement in 2004. Each category represented 17% of total identified errors.
- CFO compensation is apparently not affected by restatements as 71% of CFOs received a larger bonus in 2004 despite their company having to restate their financial statements in 2004.

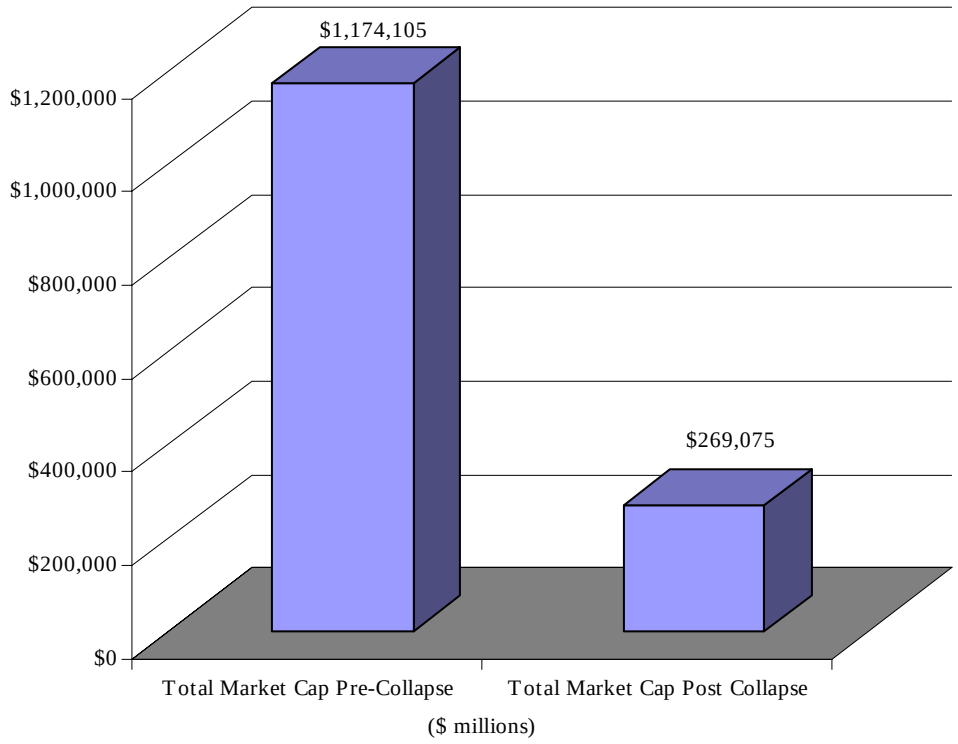
[1] In this report, the term "publicly traded company" refers to all companies publicly traded on a U.S. stock exchange except for companies that are foreign private issuers.

Important disclosure information at end of report.

The High Cost of Fraudulent Reporting

In recent years, investors have absorbed huge losses from fraudulent financial statements. Graph 1 shows the before and after market capitalizations of 30 well-publicized accounting collapses. The difference represents an investment loss of more than $900 billion.

Graph 1: Shareholder Losses from 30 Major 1997-2004 Accounting Scandals



Source: FactSet, Glass Lewis. See appendix B for a list of companies included in the graph.

Research Methodology

Most Comprehensive Examination of Restatements to Date

Before this report, no single comprehensive source of restatements was available. A variety of data sources, tools and techniques were used to identify restatements for calendar years 2003 and 2004. Glass Lewis performed a 10-K Wizard query of the Securities and Exchange Commission (SEC) EDGAR database for all 2003 and 2004 10-K/A, 10-Q/A, 10-KSB/A, and 10-QSB/A SEC filings that contained the terms "restate," "restates," "restatement," and "restated." Unless noted otherwise, figures provided for U.S. restatements represent all U.S. domiciled filers required to file Forms 10-K or 10-KSB. In all, we reviewed more than 10,000 quarterly and annual filings.

We also identified additional restatements, mainly those not filed on an "amended" return, by utilizing information sources such as Capital IQ and the Wall Street Journal. For restatements announced after August 23, 2004, we reviewed section 4.02 (Non-Reliance on Previously Issued Financial Statements) for

all filed SEC Form 8-Ks[2]. In September, 2004, the SEC Regulations Committee of the American Institute of Certified Public Accountants (AICPA), which includes principally accounting firm representatives, asked the SEC if all restatements had to be reported on Form 8-K pursuant to Item 4.02(a) of the instructions to this form. Those instructions specifically state that if the company's board of directors, or officer(s) concludes that any previously issued financial statements, covering one or more years or interim periods, should no longer be relied on due to an error in the statements, the company is required to make disclosure of certain information regarding the circumstances involved. Notwithstanding this, the accounting profession asked if filing this information on a Form 8-K could be avoided. We feel there is no question that requiring a Form 8-K filing brings greater transparency to such errors was a concern. The SEC staff did respond to the accounting profession stating they would support the view of the profession and not require all restatements be reported on Form 8-K.[3] This decision has led to significantly less transparency as we have noted numerous restatements that were done in the first quarter on 2005, for which there was not a Form 8-k filed alerting investors of the restatement.

The way restatements are communicated to investors is inconsistent, so it is possible a few restatements have been missed. That said, this study is still the most comprehensive examination of restatements to date. In fact, our U.S. restatement figures for 2003 and 2004 exceed similar figures published by the Huron Consulting Group[4] by 191 and 205, respectively – an increase of 59% and 50% (see Graph 3).

We also analyzed certain 2003 and 2004 foreign restatements. We performed a 10-K Wizard query of the SEC EDGAR database for 2003 and 2004 SEC annual Form 20-F/A and 40-F/A filings that contained the terms “restate,” “restates,” “restatement” and “restated.” We also identified additional foreign restatements, mainly those restatements not filed on an “amended” return, by utilizing Capital IQ. Obtaining complete quarterly foreign filings proved to be difficult, so we focused on examining only the annual filings and corresponding restatements for the foreign companies. Foreign restatements are examined in this report after our review of U.S. public companies.

Assumptions

Our study focused on restatements filed to correct accounting errors. We excluded restatements filed because of such things as a mandated or voluntary change in accounting principles, adding new schedules or words to the initial filing. Specifically, we excluded all amended filings which did not represent a correction of a mistake in the application of generally accepted accounting principles. In order to determine if the restatement was being filed to correct accounting errors, we relied upon the definition provided in Accounting Principle Board Opinion 20 – *Accounting Changes* (APB 20),[5] which states: Accounting errors include “mathematical mistakes, intentional and unintentional oversights, changes to generally accepted accounting principles (GAAP) from accounting principles that were not GAAP, changes in estimates which were not initially calculated using independent judgment and any misclassifications of amounts within the financial statements.”

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[2]Effective August 23, 2004, the Securities and Exchange Commission amended Form 8-K to increase the number of items reportable as significant corporate events. The previous Form 8-K required public companies to report very few significant corporate events, which meant investors often didn’t receive critical information until the issuance of the subsequent Form 10-Q or 10-K. Within the revised Form 8-K, section 4.02 relates to information relating to non-reliance on previously issued financial statements.

[3]An overview of the meeting can be found at http://www.aicpa.org/download/belt/2004_0913_highlights.pdf .

[4]2004 Annual Review of Financial Reporting Matters by Huron Consulting Group - referenced number of restatements by year for 2000 through 2002.

[5]Accounting Principle Board Opinion number 20 (APB 20):*Accounting Changes* – Paragraph 13 Correction of an Error in Previously Issued Financial Statements: “Errors in financial statements result from mathematical mistakes, mistakes in the application of accounting principles, or oversight or misuse of facts that existed at the time the financial statements were prepared. In contrast, a change in accounting estimate results from new information or subsequent developments and accordingly from better insight or improved judgment. Thus, an error is distinguishable from a change in estimate. A change from an accounting principle that is not generally accepted to one that is generally accepted is a correction of an error for purposes of applying this Opinion.”

We counted as a single restatement multiple amended filings across several periods resulting from the same underlying error or set of errors. Accordingly, if both annual and quarterly financial statements were restated, we counted them as a single event. If both annual and quarterly financial statements were restated, we classified them as a single annual restatement.

After a Restatement Has Been Announced

Key Questions

In order to assess how a restatement may affect share price, investors should be able to answer the following key questions:

1. Does the restatement impact a key valuation driver of the company's share price such as earnings or cash flow? As an example, revenue recognition errors could impact current and future earnings estimates which in turn are key valuation drivers for most companies. Other errors, such as long term vs. short term misclassification errors, are not as critical to an investor.

2. Has the underlying problem been fixed so projections can be relied upon? In other words, how comfortable do you feel about the overall quality of reported and forecasted earnings, post-restatement?

3. Did the company provide adequate insight into the "why's, when's and how's" of the restatement or gloss over the incident? The timing and quality of disclosures by the company are crucial. Inadequate transparency may indicate management is trying to hide problems from the investor.

4. What has changed within the company to reduce the likelihood of a restatement happening again?

5. Was there a material weakness in internal controls identified? If so, was the underlying control problem corrected? If not, did management adequately explain how there could be a restatement <u>without</u> a corresponding weakness in internal control?

6. Does the restatement reflect poorly on the integrity of management? In other words, was the restatement due to an error or was it due to an accounting irregularity or fraud?

7. Was there a change in auditor associated with the restatement? A change in auditor may be a sign of underlying disagreements between the auditor and company management. These disagreements could range from differences in opinion over the accounting treatment afforded certain transactions to the auditor no longer being able to rely on management's representations.

8. Does the restatement affect executive compensation? Are executive bonuses going to be repaid or reduced?

9. Is the level of communication between management, the board of directors and auditors acceptable? Does Form 8-K contain any documented disagreements?

10. Are the company's competitors restating for similar reasons?

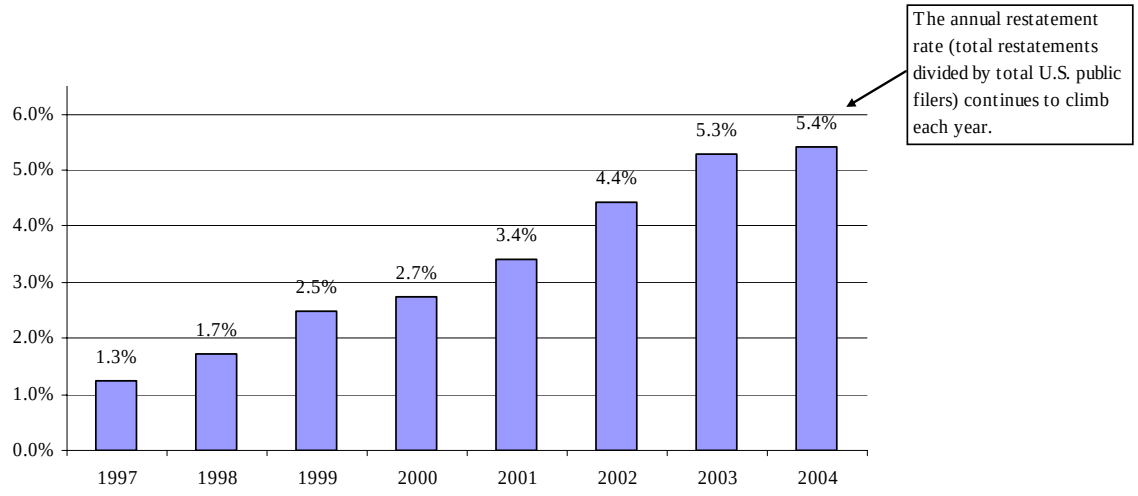
Investors will have difficulty obtaining answers to these questions because transparency relating to restatements has typically been cloudy. However, any information gained by asking these questions will give investors more insight into the potential impact of the restatement on the share price and the likelihood of another restatement in the near future.

Implications for the Investor – Restatement Trends

Number of Restatements Continue to Rise

The percentage of total U.S. domiciled publicly traded companies making accounting restatements has increased annually since 1997 (see Graphs 2 & 3 and comments relating to restatement figures provided by Huron Consulting). The restatement rate represents the number of restatements in relation to the number of U.S. public companies. From 1997 to 2004, the percentage of restatements by U.S. public companies rose from 1.3% to 5.4%.

Graph 2: Restatements as a Percentage of U.S. Domiciled Publicly Traded Companies by Year



Source: GAO,[6] Public Accounting Report,[7] Huron Consulting,[8] Glass Lewis.[9]

The actual number of accounting restatements by U.S. public companies also continues to grow. Graph 3 shows the annual change from 1997 through 2004. Accounting restatements filed to correct accounting errors rose 20%, to 619 in 2004 from 2003. Graph 3 also illustrates the difference in our Glass Lewis 2003 and 2004 U.S. restatement figures with similar figures published by the Huron Consulting Group[10]. Our 2003 and 2004 U.S. restatement figures exceed the Huron figures by 191 and 205, respectively. Most of the difference is principally due to the apparent exclusion of smaller market cap companies from the population reviewed by Huron. It also appears as if Huron excluded those filers that did not use amended returns to communicate their restatement. As a result, it appears the earlier figures reported by Huron are significantly understated. Accordingly, Huron's 1997 through 2002 figures are shown for reference purposes only.

[6]Government Accounting Office, GAO-03-138 October 2002: Financial Statement Restatements, page 16 - referenced number of publicly listed companies for 1997 through 2002.

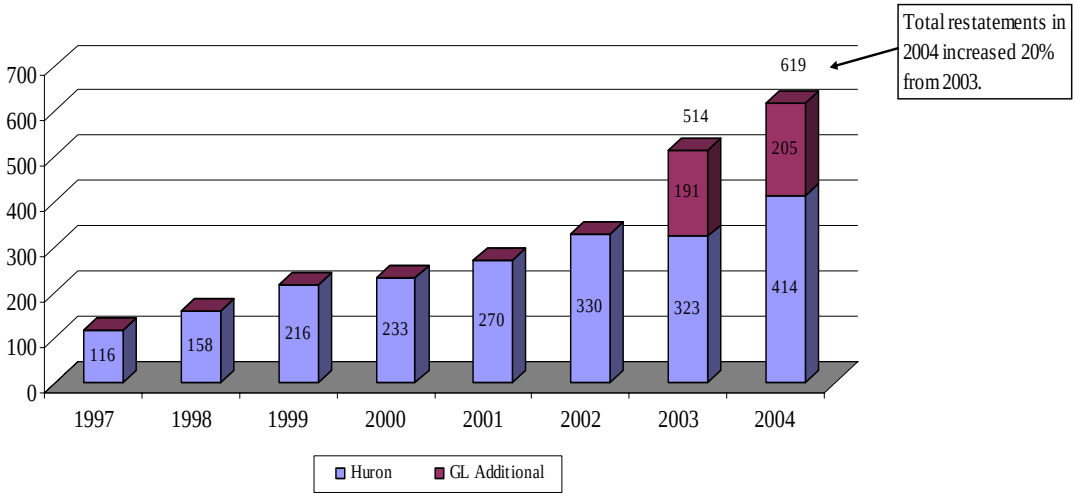
[7]Public Accounting Report - Top 100 Public Accounting Firms 2003 and 2004 - referenced number of publicly listed companies for 2003 through 2004.

[8]2004 Annual Review of Financial Reporting Matters by Huron Consulting Group - referenced number of restatements by year for 2000 through 2002. Roots of Financial Restatements - CEO Watch, The Chief Executive October 2002, source reference Huron Consulting Group - referenced number of restatements by year for 1997 through 1999.

[9]Glass Lewis - referenced number of restatements by year for 2003 through 2004.

[10]2004 Annual Review of Financial Reporting Matters by Huron Consulting Group - referenced number of restatements by year for 2000 through 2002.

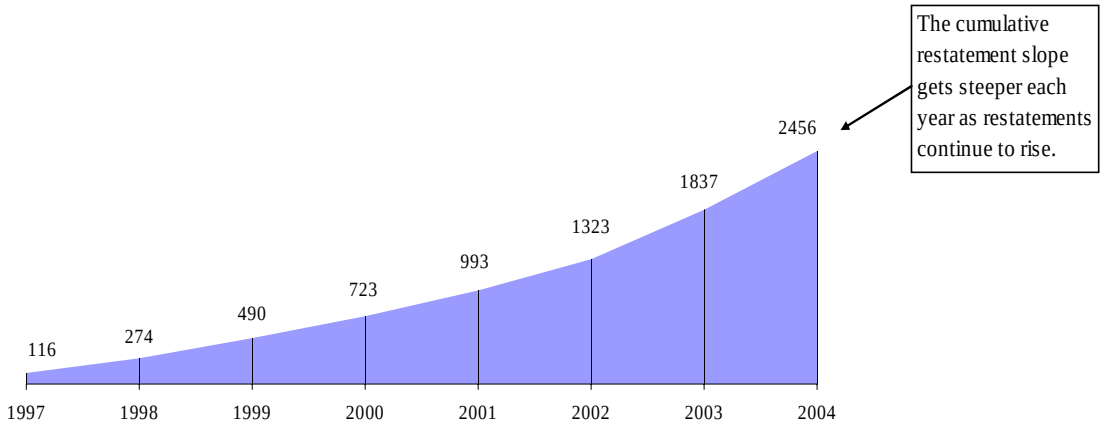
Graph 3: Total Number of Restatements by U.S. Domiciled Publicly Traded Companies by Year



Source: Huron Consulting (1997 through 2002),[11] Glass Lewis (2003 through 2004). Foreign domiciled companies listed in the U.S. are not included in this chart but are shown separately.

Graph 4 illustrates the cumulative number (i.e. each year added to previous year cumulative total) of U.S. restatements from 1997 up to 2004. Since 1997, there have been a total of 2456 restatements by U.S. domiciled publicly traded companies. As previously mentioned, this number is likely to be significantly understated due to the data collection methodology used in pre-2003 years by Huron Consulting.

Graph 4: Cumulative Annual Restatements by U.S. Domiciled Publicly Traded Companies by Year



Source: Huron Consulting (1997 through 2002), Glass Lewis (2003 through 2004).

Causes for the Increase in Restatements

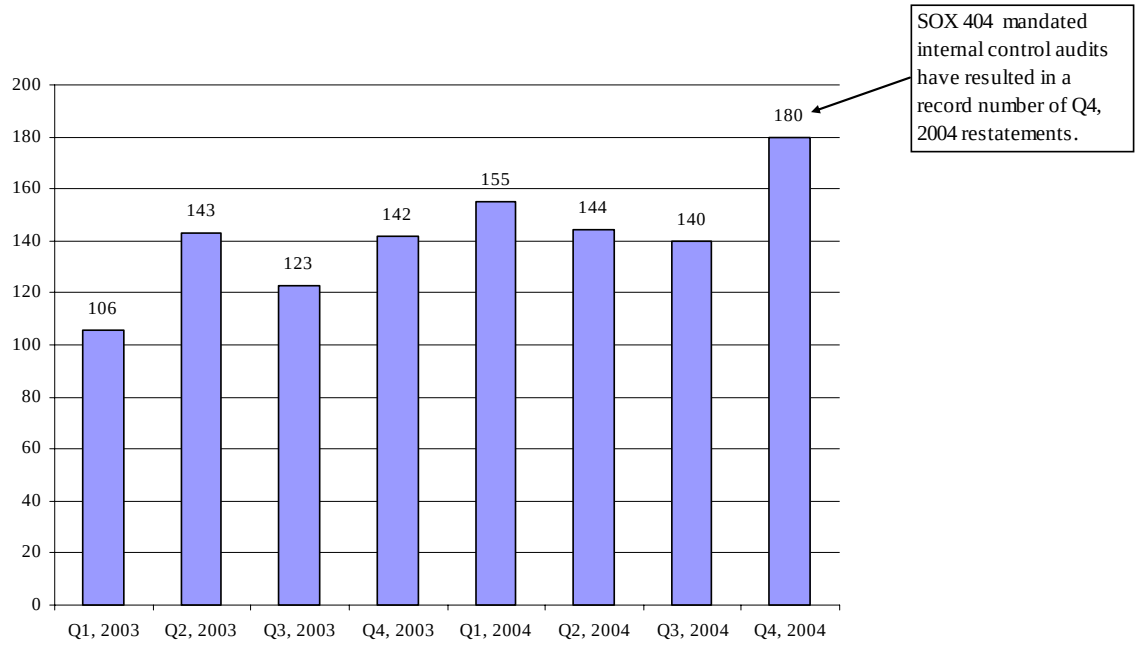
The failure by the accounting and auditing profession to detect the massive fraud perpetrated by corporate executives from Enron, Tyco, WorldCom, Adelphia, Healthsouth, Qwest, Parmalot and other companies forced investors to absorb the devastating financial consequences. However, the profession now appears to

[11] 2004 Annual Review of Financial Reporting Matters by Huron Consulting Group - referenced number of restatements by year for 2000 through 2002. Roots of Financial Restatements - CEO Watch, The Chief Executive October 2002, source reference Huron Consulting Group - referenced number of restatements by year for 1997 through 1999.

be headed in the right direction. A major factor in this turnaround is the Sarbanes Oxley legislation of 2002 (SOX) and the formation of the Public Company Accounting Oversight Board (PCAOB). The PCAOB was given audit oversight authority over the accounting profession, resulting in, we believe, more diligence by auditors with their audit related testing. With the PCAOB peering over their shoulders, auditing firms are uncovering accounting issues that may have gone previously undetected. Given the recent increase in auditor turnover, we also believe accounting firms are being especially firm about accounting errors which have been identified. As a result, many companies are being forced to restate their numbers over issues that may have once been inappropriately rationalized as acceptable or immaterial. In either event, we feel that the PCAOB has created an environment in which accounting firms operate with more caution, diligence and thoroughness. Consequently, investors should be rewarded with higher quality financial statements.

Additional SOX legislation (SOX 404) mandated an annual evaluation of a company's system of internal controls over financial reporting. The legislation also required CEO and CFO certification on the company's financial statements as well as improved corporate governance. Here again, it appears as if the SOX legislation is benefiting investors. Restatements were up, especially in the fourth quarter of 2004 as companies hustled to complete their annual internal control evaluation in time to release their annual Form 10-K report. We think SOX 404 led to a more robust examination of accounts, which in turn led to the identification of many errors in previously issued financial statements. Graph 5 provides a quarterly snapshot of restatements for 2003 and 2004 to illustrate this point.

Graph 5: Total 2003 and 2004 Restatements by Quarter



Source: Glass Lewis.

The number of restatements is also rising because, in our opinion, corporate executives continue to push the accounting envelope in order to meet quarterly earnings projections. The payback has been record levels for executive compensation via bonuses and equity incentives. A recent study found a direct correlation between equity incentives and earnings management.[12] Earnings management has taken place since the

[12]Qiang Cheng & Terry Warfield: Equity Incentives and Earnings Management, *The Accounting Review* April 2005, "As expected, we find that managers with high equity incentives are more likely to report earnings that meet or just beat analysts' forecasts. (cont.)

formation of the capital markets. Until there is a dramatic change in the way executives are compensated, earnings management will continue to represent business as usual – and investors should expect restatements to continue to increase.

Not All Restatements Are Equal: Restatement Errors by Category

Glass Lewis identified eleven major categories of individual accounting errors that drive restatements. Certain errors, such as misclassification of balances within a financial statement are obviously not as significant to investors as errors resulting from revenue or expense recognition issues or errors resulting from misjudgments made in establishing reserve balances or loss contingencies. Nonetheless, investors should know the potential impact of all errors. For example, a perceived harmless misclassification resulting in an overstatement of operating cash flows could significantly affect the key financial metrics used to determine a company's overall value or credit rating. The importance of proper classifications within financial statements was emphasized in a speech given by the deputy chief accountant of the SEC, Scott Taub, who stated:

> "Auditors also need to be cognizant of income statement classification issues. Auditors also need to be sure they gather sufficient competent evidential matter and perform rigorous audit tests to ensure all financial statement classifications are materially correct."[13]

Table 1 provides a description of the types of errors that have been grouped within each category.

Table 1: Description of Accounting Error Category

Accounting Category	Category Description
Expense Recognition	Restatements due to recording expenses in the incorrect period or for an incorrect amount.
Revenue Recognition	Restatements due to improper revenue accounting. This category includes instances in which revenue was improperly recognized, questionable revenues were recognized, or any other number of related errors that led to misreported revenue.
Misclassification	Restatements due to misclassifying significant accounting items on the balance sheet, income statement or statement of cash flows. These include restatements due to misclassifacation of short or long term accounts or those that impact cash flows from operations.
Equity - Other	Restatements due to improper accounting for EPS, restricted stock, warrants and other equity instruments.
Reserves / Contingencies	Restatements due to errors involving accounts receivables bad debts, inventory reserves, income tax allowances and loss contingencies.
Capital Assets	Restatements due to asset impairment,timing of asset place in service dates, write-downs, goodwill, or any other number of related errors.
Taxes	Restatements due to errors involving correction of tax provision, improper treatment of tax liabilities, and other tax-related items.
Equity - Other Comprehensive Income	Restatements due to improper accounting for comprehensive income equity transactions including foreign currency items, minimum pension liability adjustments, unrealized gains and losses on certain investments in debt, equity securities and derivatives.
Inventory	Restatements associated with inventory costing valuations, quantity issues and cost of sales adjustments.
Equity - Stock Options	Restatements due to improper accounting for employee stock options.
Other	Any restatement not covered by the listed categories including those related to improper accounting for acquisitions or mergers.

Source: Glass Lewis.

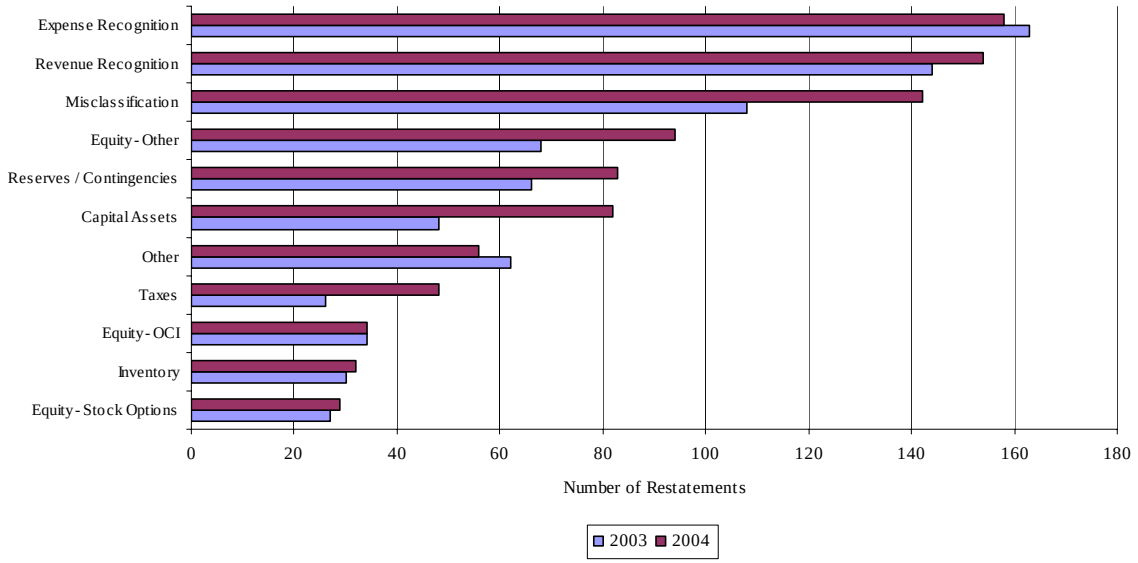
We also find that managers with consistently high equity incentives are less likely to report large positive earnings surprises. This finding is consistent with the wealth of these managers being more sensitive to future stock performance, which leads to increased reserving of current earnings to avoid future earnings disappointments. Collectively, our results indicate that equity incentives lead to incentives for earnings management."

[13]Scott A. Taub, U.S. Securities & Exchange Commission - 28th Annual National Conference on Current SEC Developments December 4, 2000.

A significant amount of judgment is required to determine the appropriate error category for each restatement. When companies issue restatements, management will often-times make multiple adjustments that cross several categories and fall under the rubric of a financial house cleaning. This tactic makes it difficult to determine a single underlying error for a restatement. When we could not identify a single accounting error category driving the restatement, we assigned multiple reasons to the restatement. Consequently, the number of identified errors exceeds the number of restatements.

In 2004, expense recognition and revenue recognition errors were the most commonly made errors leading to a restatement. Each category represented 17% of total identified errors. Expense recognition errors occur when expenses are recorded in the incorrect period or for an incorrect amount. The number of expense and revenue recognition errors remained relatively constant in 2003 and 2004. Graph 6 provides an overview of the actual number of errors identified by category

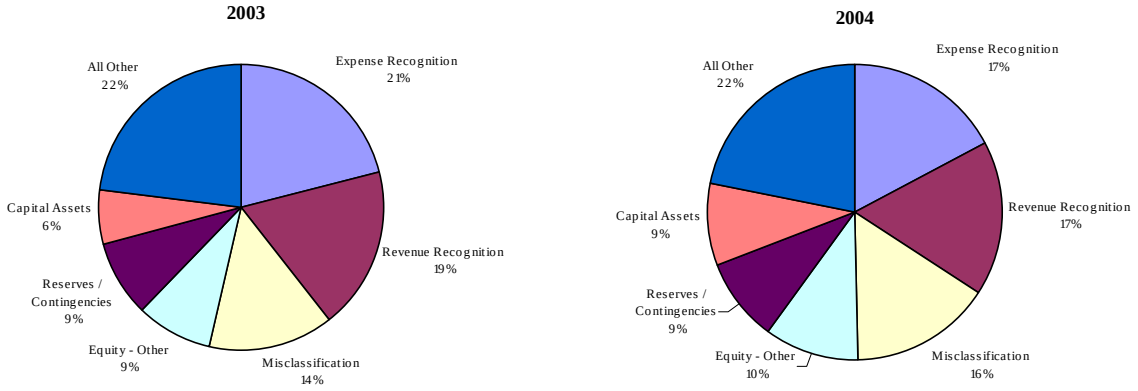
Graph 6: Total Number of Restatements in 2003 and 2004 by Error Category



Source: Glass Lewis.

Graph 7 displays each error category as a percentage of total errors identified.

Graph 7: Total 2003 and 2004 Restatements by Error Category – Percentage of Total



Source: Glass Lewis.

The typical expense recognition error was made by failing to properly accrue for expenses at the end of a period. Incorrect accounting for operating lease obligations also drove up expense recognition error figures. Errors related to operating leases are affecting 2005 restatement numbers even more than in 2004. In February 2005, the SEC reiterated long standing rules for accounting for leases that contain renewals, rent holidays or incentives. The restatement floodgates were opened.[14] According to Accounting Observer's Jack Ciesielski, 261 public companies have either restated their financial statements, recorded a cumulative "catch-up" adjustment or are contemplating a restatement for leases.[15] Fewer than 10% of these restatements took place in 2004.

Revenue recognition errors have historically been the leading cause of restatements and are second to none in investor importance. The SEC has found revenue recognition restatements result in the largest drops in market capitalization.[16] Of equal importance is the estimate that more than 50% of financial reporting frauds involve the overstatement of revenue.[17]

Year to Year Changes in Type of Errors

An investor's ability to predict the future risk of restatement is improved by examining the recent growth trend of each error category. Table 2 illustrates the changes.

Table 2: Change in Restatement Error Categories - 2003 to 2004[18]

	2003	2004	Yr. to Yr. Change
Taxes	26	48	85%
Capital Assets	48	82	71%
Equity - Other	68	94	38%
Misclassification	108	142	31%
Reserves / Contingencies	66	83	26%
Equity - Stock Options	27	29	7%
Revenue Recognition	144	154	7%
Inventory	30	32	7%
Equity - OCI	34	34	0%
Expense Recognition	163	158	-3%
Other	62	56	-10%

Source: Glass Lewis.

Errors relating to taxes increased the most of any category – 85%. The increase is due largely to inaccurate or improper transfer pricing affecting the income tax provision. We also suspect it is the direct result of the SEC staff appropriately highlighting the accounting for income taxes as an area of concern. In addition, several errors were related to improper accounting for foreign taxes. The 71% increase in capital asset errors can be primarily attributed to incorrect accounting for asset impairments. The majority of the

[14] Letter from SEC Chief Accountant Donald T. Nicolaisen to AICPA, dated February 7,2005- http://www.sec.gov/info/accountants/staffletters/cpcaf020705.htm

[15] The AAO Weblog dated April 22, 2005 by Jack Ciesielski: General Leasing Makeovers Restatement Zoo - http://www.accountingobserver.com/blog/category/leasing-makeovers/

[16] Speech by SEC Staff: Revenue Recognition - Remarks by Lynn E. Turner SEC Chief Accountant May 31, 2001.

[17] Fraudulent Financial Reporting: 1987-1997 An Analysis of U.S. Public Companies, sponsored by the Committee of Sponsoring Organizations (COSO) of the Treadway Commission March 1999.

[18] Total number of errors exceeds total number of restatements as certain restatements contained multiple errors.

impairment errors were related to either incorrect assumptions used in the methodology to calculate the charge or the impairment was recorded in the incorrect period. Impairment errors in 2004 also increased due to difficulties related to the implementation of Emerging Issues Task Force (EITF) Issue No. 03-1: *The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments*.

Errors in the Equity–Other category increased 38% because several companies failed to account properly for restricted stock compensation. Misclassification errors increased from 2003 to 2004 by 31%. The increase, as well as the majority of actual misclassification errors identified fall into three general categories: 1) misclassifications between revenue/cost of sales on the income statement; 2) misclassifications between short and long term liabilities on the balance sheet and 3) misclassifications between operating cash flow and other cash flow categories on the statement of cash flows. In our opinion, questionable management judgment and the ability to intentionally manipulate reserves and contingencies led to the 26% increase in errors related to reserves and contingencies.

Future Restatement Drivers

Investors should expect other issues to drive up the restatement rate in 2005 and beyond. We previously discussed the impact of leases and increases in executive compensation. Accounting for securitizations under Statement of Financial Accounting Standard (SFAS) 140 *Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities* is a major problem area for many companies heavily involved with securitization transactions. Investors should not be surprised to see companies bringing securitization transactions back on the balance sheet as a large number of the historical transactions effectively transferred minimal risk of the ultimate realization of the asset to the purchaser. With the publicity surrounding Fannie Mae's and AIG's restatements caused by their improper accounting for derivatives, investors should expect an increase in the number of companies reporting similar issues. While accounting guidance provided for derivatives[19] is complex, it has been the simpler, straightforward hedging valuation transactions that have created many of the accounting problems. Fannie Mae is being forced to restate its financials to reverse certain hedge accounting transactions. AIG may have been undervaluing hedged positions in order to manage quarterly income.

Sectors and Industries Most Prone to Restatements

The technology sector[20] has been viewed traditionally as high risk, high reward. Unfortunately for investors, one of the assumed risks was overly aggressive accounting that often resulted in less reliable financial statements prone to restatement. Indeed, the restatement rate in the technology sector remains high - more than 6% in 2004 - but the ominous distinction of being the restatement leaders now belongs to the utilities and services sectors.

In 2004, the 181 companies in the utilities sector had a restatement rate of more than 13%, over 50% higher than any other sector. Major utility companies such as Calpine, Commonwealth Energy and Dayton Power and Light all restated. The most common drivers behind the restatements were improper accounting for derivatives (FAS No. 133), primarily those associated with historical hedges of natural gas, and improper lease accounting. Restatements by communications services giants such as WorldCom/MCI, Qwest and Sprint, as well as restatements by broadcasting services companies such as Cablevision, Echostar, Time Warner and Liberty Media pushed the services sector to second on the list.

Graph 8 illustrates restatement rates for 2003 and 2004 by sector.[21] Note the minimal changes from year to year in the order of segments. The exception was the conglomerate sector, which was skewed in 2003 by

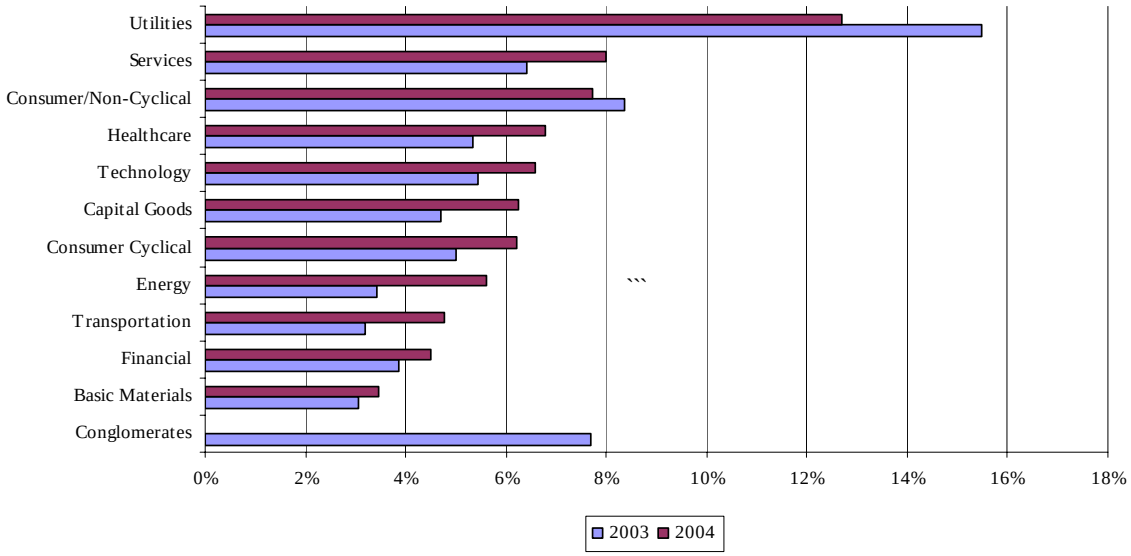
[19] SFAS 133 - *Accounting for Derivatives and Hedging Activities.*

[20] Sector classifications provided by Reuters.

[21] Appendix A provides a detailed listing of specific industries within each sector. Industry classifications provided by Reuters.

the low number of companies classified as conglomerates and multiple Tyco restatements.[22] There were zero restatements in 2004 for conglomerates.

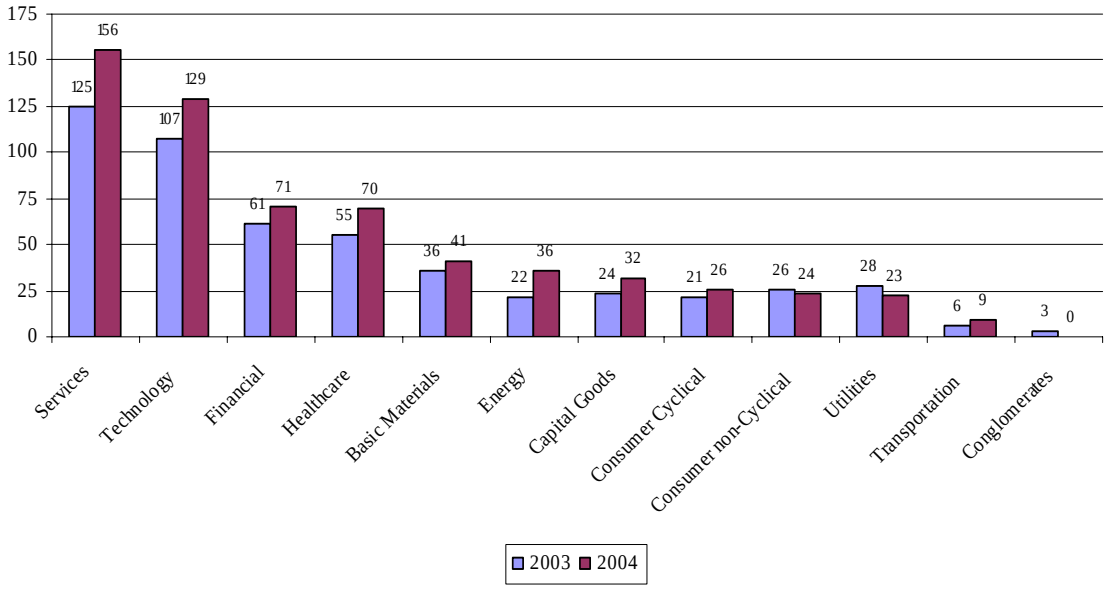
Graph 8: Restatement Rate by Industrial Sector



Source: FactSet, Glass Lewis.

Graph 9 compares the number of restatements by sector. The services and technology sectors generate the largest actual number of restatements each year. Restatements increased in nine out of the twelve sectors in 2004. The 64% increase in 2004 energy sector was the largest year-to-year percentage increase.

Graph 9: Annual Number of Restatements by Industrial Sector

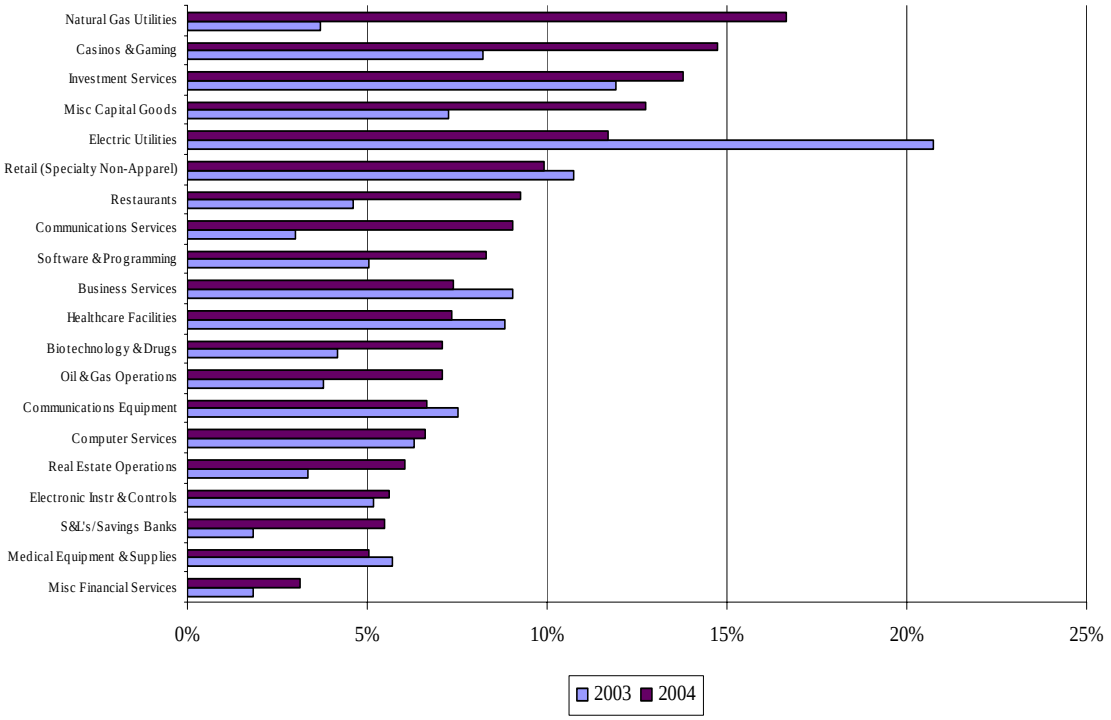


Source: FactSet, Glass Lewis.

[22]For the purposes of this report, multiple amended reports filed for the same period but for different are individual restatements.

A further breakdown of the sector information is provided in our evaluation of restatement data by key industry within each sector (see Appendix A for a listing of industries by sector). Graph 10 provides an overview of the restatement rate by key industry.[23] In 2004, the natural gas industry had the highest restatement rate of all industries. The primary driver was improper accounting for derivatives (Statement of Accounting Financial Standard No. 133), primarily those associated with historical hedges of natural gas.

Graph 10: Restatement Rates by Key Industry - Top 20



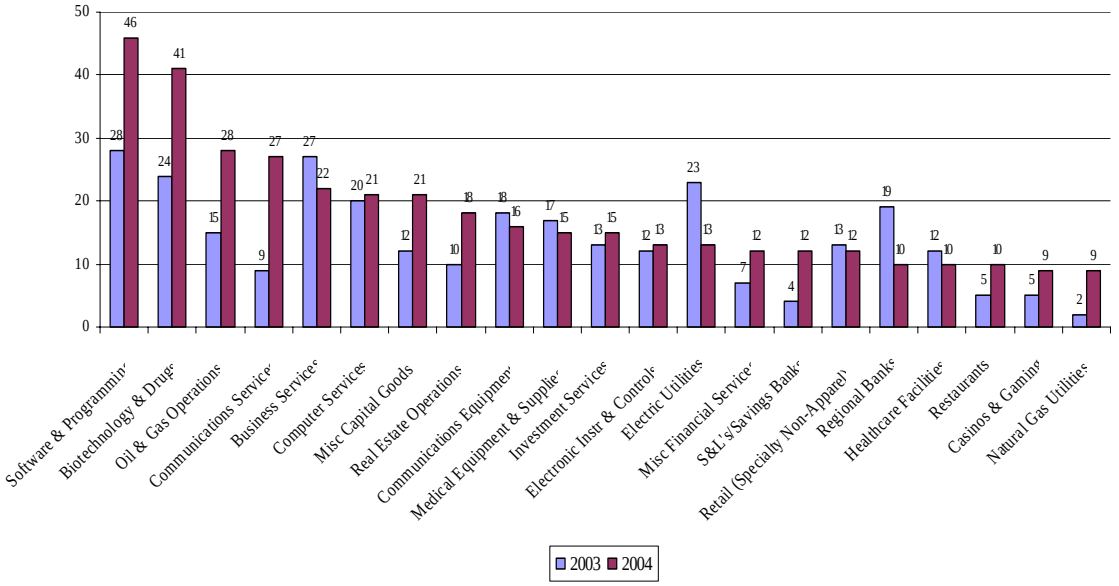
Source: FactSet, Glass Lewis.

Casinos and gaming companies generated the second-highest restatement rate among the industry groups although there was not a single predominant error type within the group. The 2004 restatement rate for the communication services industry doubled compared to 2003. The primary causes were adjustments made to correct impairment charges in addition to restatements made to record expenses in the proper period.

On an industry basis, software and biotech had the largest number of restatements in 2004. Among the 46 software companies that restated in 2004 were McAfee and Red Hat, which each had accounting issues related to revenue recognition. Revenue recognition was also a major issue for the 41 biotech companies restating in 2004. These two industries, along with the oil & gas and communication services, saw sharp increases in 2004 restatements. A comparison of the actual number of restatements by industry is provided in Graph 11.

[23] Industry graph displays the top 20 industries with at least 9 restatements in 2004.

Graph 11: Annual Number of Restatements by Key Industry - Top 20

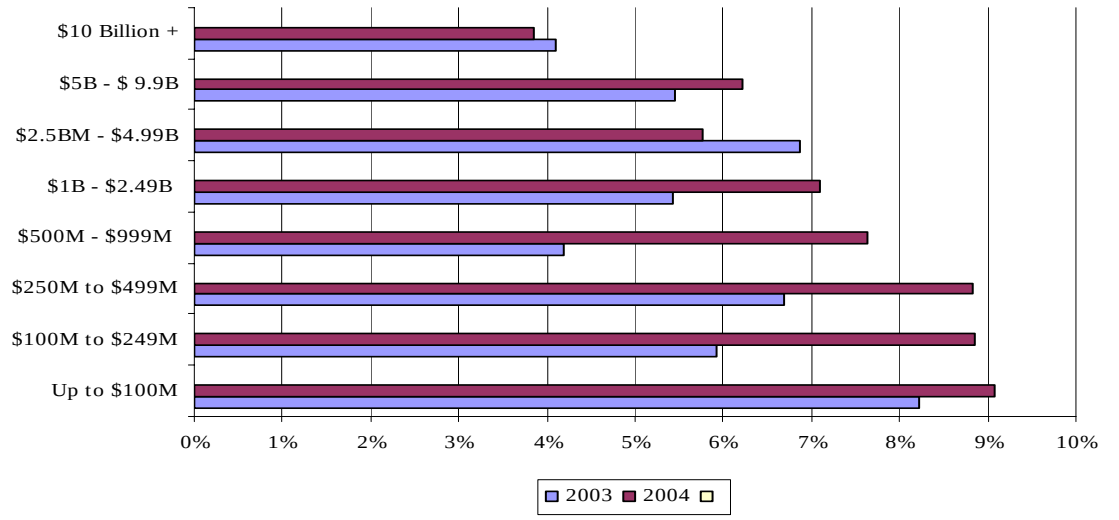


Source: FactSet, Glass Lewis.

Smaller Companies Most Likely to Restate

In 2004, companies with less than $500 million in revenue were more than twice as likely to restate as companies with more than $10 billion in revenue. The smallest companies have a restatement rate of 9%; the largest companies have a restatement rate of 4%. Smaller companies may have limited accounting and auditing resources but they also tend to be less complex and less global. Larger companies may also benefit from "materiality," meaning that errors identified in an audit of a $10 billion-plus company have to be extremely large in order to materially impact the financial statements. However, SEC Staff Accounting Bulletin (SAB) No. 99 notes that intentional errors, regardless of materiality or company size, may well require a restatement. Graph 12 illustrates the difference in 2004 restatement rates based on revenue.

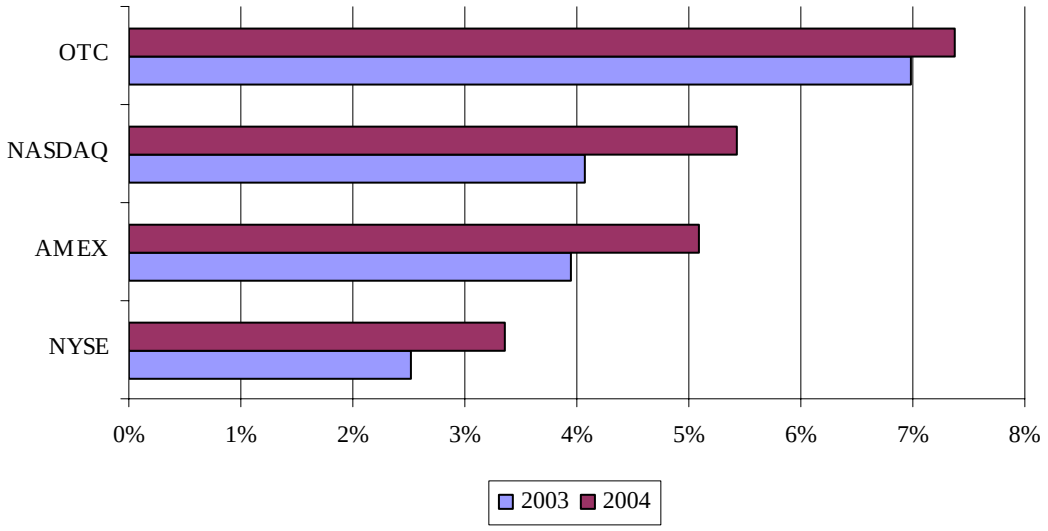
Graph 12: Annual Restatement Rate by Company Revenue



Source: FactSet (excluding those companies whose revenue was not available), Glass Lewis.

Graph 13 illustrates companies listed on the OTC exchanges are more than twice as likely to restate as companies listed on the NYSE.

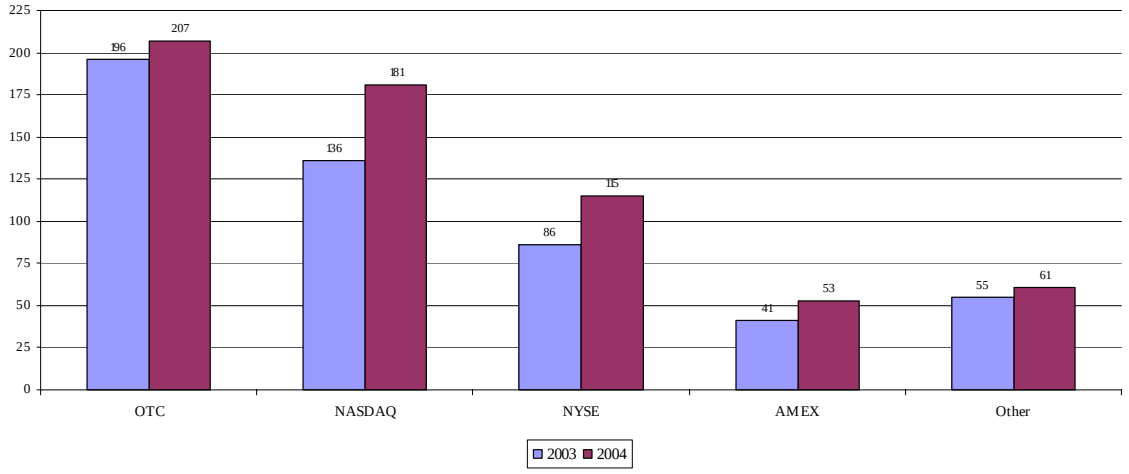
Graph 13: Restatement Rate by Stock Exchange



Source: FactSet, Glass Lewis.

Graph 14 compares the number of restatements by stock exchange. The OTC and NASDAQ exchanges generated the largest actual number of 2004 restatements. All exchanges registered an increase in restatements in 2004 vs. 2003. The largest increases occurred within companies listed on the NYSE (34%) and NASDAQ (33%).

Graph 14: Actual Number of Restatements by Stock Exchange

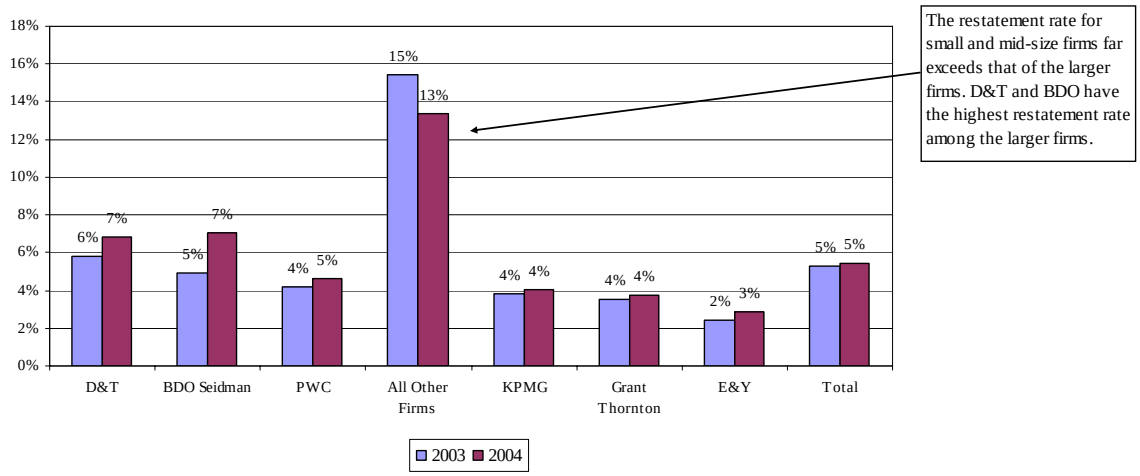


Source: FactSet, Glass Lewis.

Smaller Audit Firms Fail the Test

The risk of restatement for public companies audited by small and mid-sized accounting firms is nearly three times as high as that for companies audited by the largest firms. Graph 15 provides illustrates restatement rates by accounting firm.

Graph 15: Average Restatements per Number of Public Clients



Source: Public Accounting Report on the Top 100 Public Accounting Firms for 2003 and 2004,[24] Glass Lewis.

Approximately five out of every hundred public companies issued restatements in 2004. The Big Four firms were split. Two were under this average (Ernst & Young and KPMG) while two were above. Among the Big Four, Deloitte & Touche (D&T) had the highest restatement rate (restatements per number of public companies audited)[25] in both 2003 (6%) and 2004 (7%). BDO Seidman (BDO) also had a restatement rate of 7% in 2004. Both firms are more than 400 bps higher than the firm with the lowest restatement rate in both years, Ernst & Young (E&Y). The restatement rate for all the six of the largest firms increased in 2004. The 200 bps increase by BDO is the highest year-to-year increase. The "all other firms" combined category, consisting of smaller regional and local firms, reduced its 2004 restatement rate by nearly 200 bps.

A low restatement rate may indicate 1) the firm does a better job of correcting errors before a company publishes bad numbers, 2) the firm performs audits on companies concentrated in less complex industries or 3) the firm rationalizes away errors identified in prior filings and fails to correct them due to potential litigation risks. Conversely, a firm with a higher restatement rate may indicate the opposite.

A Fresh Set of Eyes May Help

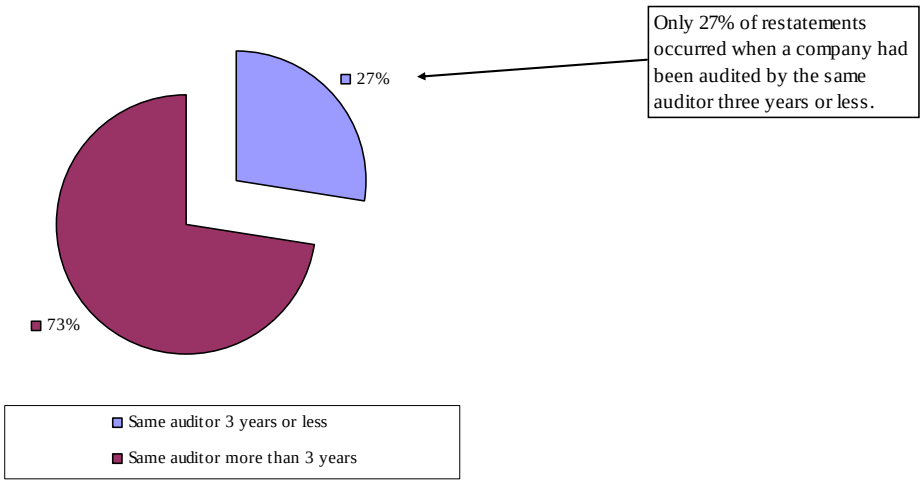
Nearly three quarters of the companies that restated in 2003 and 2004 had been audited by the same auditor for more than three years. Proponents of auditor rotation have long argued that long-term auditors get too cozy with the companies they audit and lose their objectivity. We believe three years is sufficient time for

[24] Excluding any public companies not audited by any of the top 100 public accounting firms will not significantly change figures shown in the graph.

[25] Restatement rate calculated as the number of filed restatements in 2003 and 2004 where the accounting firm is the "auditor of record" for the financial statements being restated. The restatements figure is divided by the total number of publicly traded companies audited in 2003 and 2004 by the respective accounting firms. This total number of 2003 and 2004 publicly traded companies audited by firm was obtained from the Public Accounting Report on the Top 100 Public Accounting Firms.

auditors to gain a good understanding of the business. Graph 16 displays the auditor length of service results from our study.

Graph 16: Auditor Length of Service at Companies Which Restated in 2003 or 2004



Source: Capital IQ, Glass Lewis.

Investors Beware of a Change in Auditor

However, when there is a change in auditor an investor should be alerted to the fact that a restatement coupled with a change in auditor could indicate serious problems within a company. Potential problems could include overly aggressive or fraudulent accounting practices, unscrupulous management and material weaknesses in internal controls or weak corporate governance by the board of directors. Graph 17 illustrates that 20% of restatements in 2003 and 2004 have been accompanied by a change in auditor. By contrast, the average auditor turnover rate for those years is 12%.[26]

Graph 17: Restatements and Change in Auditor

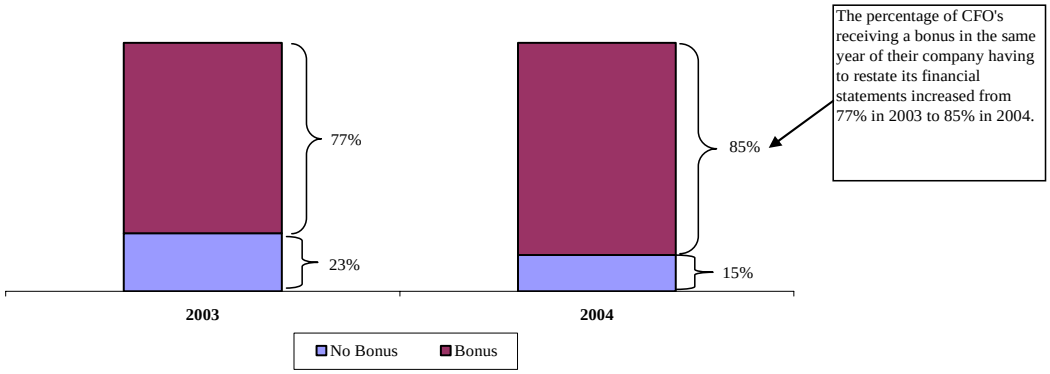
Source: SEC Edgar; Glass Lewis.

[26] Average auditor turnover calculation based upon total auditor turnover in 2003 and 2004 per Glass Lewis database divided by total number of public companies per the Public Accounting Report on the Top 100 Public Accounting Firms.

Executive Compensation Largely Unaffected by Restatements

CFO compensation is apparently not affected by restatements. Even though a significant aspect of a CFO's job is to ensure adequate controls exist to prevent issues such as restatements, the percentage of CFOs receiving a bonus in the same year as their company restating its financial statements increased from 77% in 2003 to 85% in 2004. Graph 18 displays this increase. "Clawing back" or recapturing bonuses based upon inaccurate financial statements is a recent corporate governance development. In general, claw back provisions have met with moderate success. Nortel, for example, has stated the company will aggressively retrieve $10 million in performance bonuses that were paid out to executives based upon financial statements subsequently restated numerous times. In another case, Rep. Richard Baker, R-Baton Rouge, has demanded that Fannie Mae executives return bonuses that were "awarded based upon the faulty and deeply flawed earnings statements of the enterprise."[27] By contrast, Computer Associates' shareholders rejected, by a margin greater than three to one, a proposal to recover executive bonuses after a restatement that reduced the company's 2000 and 2001 earnings by more than $2 billion.[28]

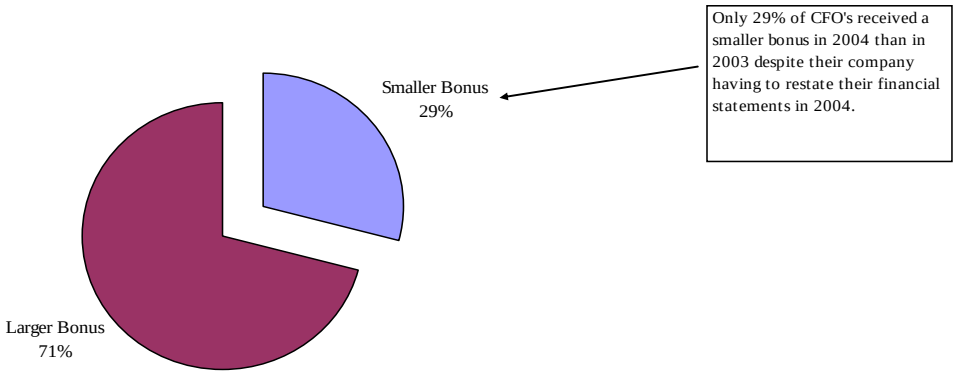
Graph 18: CFOs Receive Bonuses Despite Restatement



Source: Glass Lewis.

Not only did a higher percentage of CFOs receive bonuses in 2004, 71% of these CFOs received a larger bonus than in 2003. Graph 19 illustrates lack of connection between CFOs bonus compensation and restatements.

Graph 19: 2004 Bonuses Paid to CFOs Increase Despite 2004 Restatement



Source: Glass Lewis.

[27] Washington Post: Fannie Mae Bonuses Targeted, Legislator Asks for Money to Be Returned - Kathleen Day, January 6, 2005.
[28] CNET News.com: CA execs hold on to million-dollar bonuses - Martin LaMonica, August 26, 2004.

We reviewed CFO compensation for companies that had a restatement in either 2003 or 2004. Specifically, we were looking for the financial impact, if any, on CFO bonuses after a company was required to restate. We uncovered several companies at which we consider the compensation to be egregious in light of their accounting problems. Table 3 displays three of the more blatant examples.

Table 3: Increasing CFO Compensation Despite Material Weaknesses & Restatements

			Date Became	2004 Compensation			2003 Compensation		
Company Name	Name	Title	CFO	Salary	Bonus	Stock	Salary	Bonus	Stock
El Paso Corp. (EP)	D. Dwight Scott	CFO	10/2002	$453,929	$498,644	$739,200	$517,504	$750,000	$0
Goodyear (GT)	Richard J. Kramer	CFO	6/1/2004*	$378,750	$587,704	$0	$0	$0	$0
SunTrust Banks (STI)	John W. Spiegel	CFO	08/2000	$455,000	$504,140	$0	$500,000	$400,000	$239,918

Source: Company Reports, GLC. *Prior to being named CFO, Mr. Kramer served as Goodyear's principal accounting officer until August 2002.

El Paso Corporation has experienced a litany of accounting problems in recent years. In fact, El Paso has been required to restate its financial statements three times in the last two years due to errors that include inaccurate reserve estimation techniques, improper acquisition accounting and improper accounting for a discontinued subsidiary. The annual periods affected by these restatements range from 1999 to 2003. In addition, El Paso disclosed material weaknesses in each of its last two annual reports. Most notably, the weaknesses related to a lack of security over access to computer systems used by both IT and the financial reporting and accounting staff. Other control problems included poor account reconciliation procedures within the accounting department as well as a general inability to properly interpret and implement complex accounting standards. Despite what we view as an abysmal track record with its internal accounting and overall system of internal accounting controls and even though the internal control problems still have not been fixed, the El Paso CFO was paid a $0.5M bonus and nearly $0.75M in stock compensation in 2004. The 2004 El Paso 10-K revealed the existence of material weaknesses in the company's internal controls over financial reporting. Specifically, the company was cited by its auditor for not maintaining effective controls over "(1) access to financial applications programs and data, (2) account reconciliations and (3) identification, capture and communication of financial data used in accounting for non-routine transactions or activities"[29].

Goodyear has also disclosed material weaknesses in its last two annual reports. In addition, Goodyear has restated its annual financial statements twice in the last two years. The first restatement resulted from a review of internal controls that found issues relating to un-reconciled accounts. The second restatement was required after management uncovered widespread fraudulent accounting in its European Union Tire business segment as well as accounting irregularities resulting in the understatement of the company's workers' compensation liability. The annual periods affected by these restatements were 1998 through 2002. Goodyear's current CFO, Richard Kramer, joined the company in March 2000. One month later, Kramer was elected vice president of corporate finance, serving as the company's principal accounting officer until August 2002.[30] Kramer became Goodyear's CFO in June 2004. Despite Kramer's role as principal accounting officer for a large part of the periods that were restated and despite continuance of internal control problems, Goodyear management paid the CFO a bonus of nearly $0.6M in 2004.

In October 2004, SunTrust Banks announced it was restating its financial statements for the first two quarters of 2004 due to a misstatement in the company's allowance for loan losses. A similar restatement had been required in 1998. The misstatement was a result of errors and internal control deficiencies. In

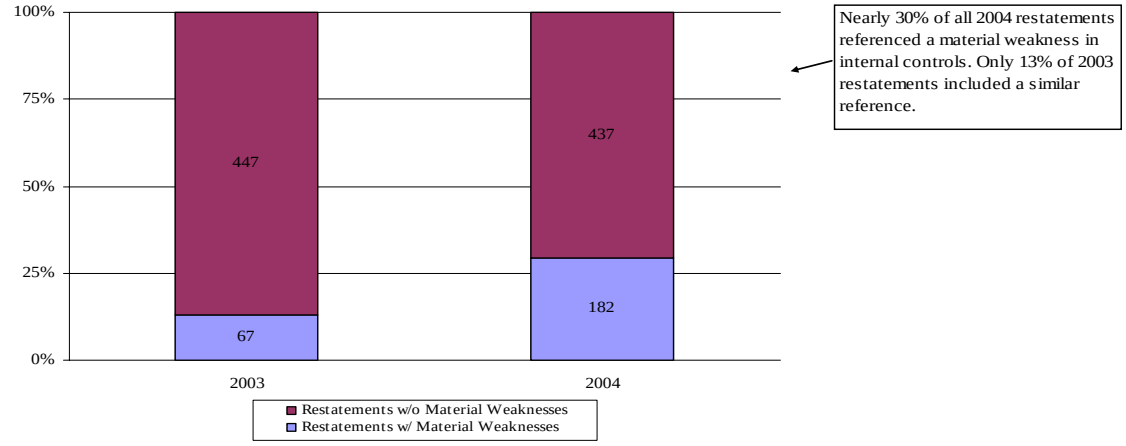
[29] El Paso Corp. SEC Form 10-K for the year ending December 31, 2003 filed on March 28, 2005.
[30] Obtained from Reuters' Company Officers' Biographies - http://yahoo.investor.reuters.com.

January 2005, the company officially disclosed a material weakness in internal controls relating to the process for establishing the allowance for loan and lease losses. Despite the required restatement and the identification of a material weakness over one of the most critical accounts in a banks balance sheet, SunTrust's CFO received a 25% increase in his 2004 bonus.

Restatements and Material Weaknesses in Internal Controls

How can you invest in a company if you can't rely on their financial statements? Investors depend heavily on the reliability of a company's system of financial reporting and the corresponding financial statements. Accordingly, investors should take notice when restatements associated with material weaknesses in internal control increased 172% from 2003 to 2004. Graph 20 shows the rapid growth in material weaknesses.

Graph 20: Annual Growth in Restatements with Material Weaknesses



Source: Glass Lewis.

When management discloses their company has a material weakness in internal control, they are in effect telling investors: There is greater than a remote chance that a material misstatement will not be prevented or detected in their company's financial statements.[31] A disclosed weakness and lack of fidelity in the company's financial statements is not good for investors, who could be negatively affected by a dip in both a company's share price and credit ratings. The investor must also consider the potential impact to a company when audited financial statements are not available due to delays caused by the evaluation of internal controls.[32] Failing to issue timely financial statements could jeopardize a company's ability to obtain credit financing or, worse, put a company in default of existing credit arrangements.

Section 404 of the Sarbanes Oxley Act (SOX 404) mandates an independent audit of a company's system of internal controls over financial reporting in conjunction with the annual audit of a company's financial statements. The internal control audit requirement is effective for all fiscal years ending after November 15,

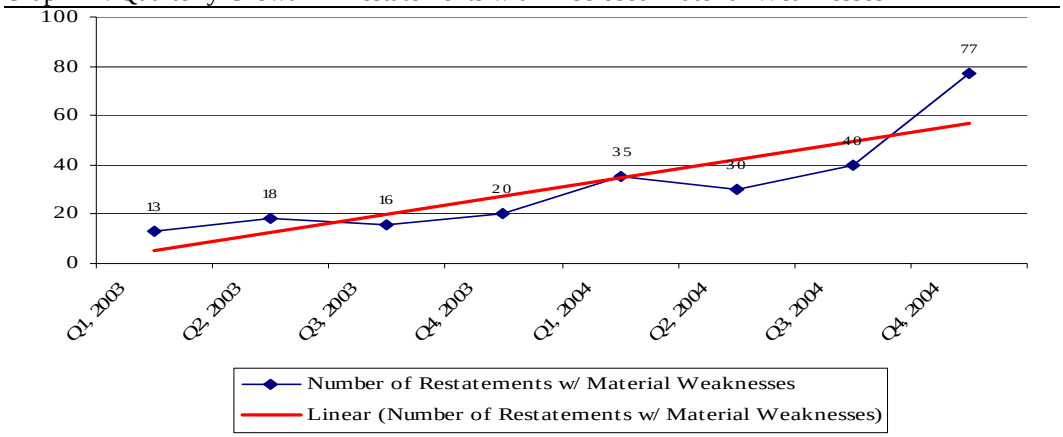
[31]Public Company Accounting Oversight Board Bylaws and Rules – Standards – AS2: "A *material weakness* is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected."

[32]Public Company Accounting Oversight Board Bylaws and Rules – Standards – AS2, paragraph 175: If there are significant deficiencies that, individually or in combination, result in one or more material weaknesses, management is precluded from concluding that internal control over financial reporting is effective. In these circumstances, the auditor must express an adverse opinion on the company's internal control over financial reporting."

2004, therefore, one would expect a significant increase in material weakness disclosures in the fourth quarter of 2004.

Graph 21 confirms this finding. The number of restatements with a corresponding disclosure of material weaknesses more than tripled, increasing from 20 in Q4, 2003 to 77 in Q4, 2004. On an annual basis, the increase was 172%, increasing from 67 in 2003 to 182 in 2004. Investors should expect this increase to continue through 2005 as auditors complete the audits of calendar 2004 and fiscal 2005 annual financial statements. For companies that the SEC does not consider to be "accelerated filers,"[33] expect restatements to increase in the latter half of 2005 because these companies were not required to have an audit of their internal controls completed until the completion of the audit of their 2005 financial statements.

Graph 21: Quarterly Growth in Restatements with Disclosed Material Weaknesses



Source: Glass Lewis.

All Material Weaknesses are Not Equal

Investors need to evaluate the facts behind a company's disclosure of a material weakness so they can understand its potential implications on the company's system of financial reporting and corresponding financial statements. SEC Chief Accountant Donald T. Nicolaisen has stated the severity of a material weakness can not easily be categorized. "One category for example," he said, "might include a material weakness whose effects are limited to a single account balance that an auditor could address by expanding audit procedures. Another category might include an ineffective control environment, such as the tone at the top, an ineffective audit committee or an ineffective financial reporting process."[34]

Our review of restatements with disclosed material weaknesses identified several companies whose disclosed material weaknesses should have its current investors pulling out the antacids. Two examples of what we consider more severe control weaknesses are:

1. Highwoods Properties Inc. (HIW), a large real estate trust, revealed in a recent filing that on "October 26, 2004, Ernst & Young LLP advised our Audit Committee that they identified the

[33] Accelerated filers are those public "domestic reporting companies that have a public float of at least $75 million that have been subject to the Exchange Act's reporting requirements for at least 12 calendar months and that previously have filed at least one annual report." - Securities and Exchange Commission, 17 CFR PARTS 210, 229, 240 and 249[RELEASE NOS. 33-8128; 34-46464; FR-63; File No. S7-08-02] RIN 3235-AI33: Acceleration of Periodic Report Filing Dates and Disclosure Concerning Website Access to Reports.

[34] Speech by SEC Staff: Keynote Speech at 11th Annual Midwestern Financial Reporting Symposium by Donald T. Nicolaisen, Chief Accountant U.S. Securities and Exchange Commission Chicago, IL October 7, 2004

following material weaknesses during their audits of the restated financial statements for 2003, 2002 and 2001:

- Inadequate procedures for appropriately assessing and applying accounting principles to complex transactions;
- Lack of adequate finance and accounting staff to appropriately identify and evaluate accounting for transactions;
- Inadequate procedures to ensure critical information regarding a transaction is known by the persons accounting for such transaction;
- Lack of application of GAAP to transactions due to perceived immateriality of transactions."[35]

2. Footstar Inc. (FTSTQ), a specialty footwear retailer, disclosed in a recent filing that "the Company has concluded that the following internally identified control deficiencies constituted "material weaknesses" including:

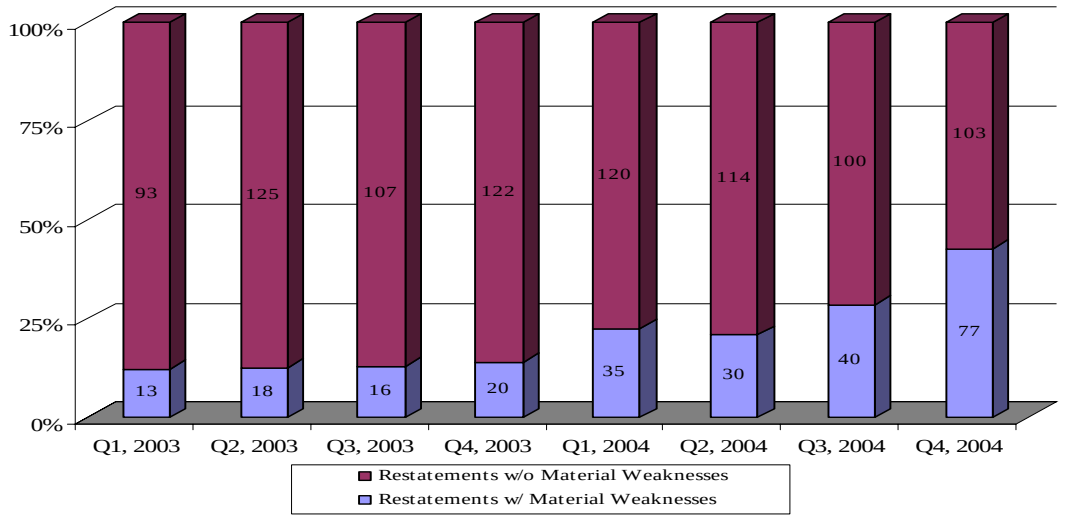
- "Tone at the Top" - Need to improve the control environment at the Company.
- Organization and Structure - Some levels of the organization were not being sufficiently trained, staffed or supervised to perform as expected.
- Management Override of Controls - Vendor payables were written off to reduce expenses.
- Payroll Withholding - Improved procedures are required to eliminate the significant number of tax deficiency notices being received, specifically in the payroll withholding area.
- Controls are required to quantify and record changes to reserves required for estimated adjustments.
- Stronger controls over inventory reconciliation procedures need to be implemented.
- Warehouse Shrink - There was a lack of controls over and accountability for inventory shipped between distribution centers and stores."[36]

A key question investors should ask is: Can a company have a restatement without disclosing a material weakness in internal controls? We believe investors should be concerned about undisclosed risks if a company restates its financial statements but doesn't own up to problems with its internal controls. Our study indicates, however, that 57% of the filed restatements in the fourth quarter of 2004 did not include a material weakness disclosure. PCAOB Auditing Standard Number Two states the "identification by the auditor of a material misstatement in the financial statements that was not initially identified by the company's internal control over financial reporting, is a strong indicator of a material weakness."[37] We agree.

Graph 22 shows the number of restatements with a disclosed material weakness is rising, fueled in part by Sarbanes Oxley section 404 requirements which required most calendar year-end companies to have an assessment of their system of internal controls for financial reporting completed prior to filing their 2005 financial statements.

[35] Highwoods Properties, Inc. SEC Form 10-K/A for the year ending December 31, 2003 filed on November 15, 2004.
[36] Footstar, Inc. SEC Form 10-K for the year ending December 31, 2002 filed on September 2, 2004.
[37] Public Company Accounting Oversight Board Bylaws and Rules – Standards – AS2.

Graph 22: Relationship by Quarter between Restatements and Disclosed Material Weaknesses



Source: Compliance Week; Glass Lewis.

Our review of fourth quarter 2004 restatements that don't disclose a material weakness identified several companies at which it appears the quality of the auditor's work is questionable. One egregious example is:

> Island Pacific Inc. (IPI), a small software company audited by the firm Singer Lewak Greenbaum & Goldstein. Island Pacific management filed amended financial statements for the prior fiscal year and several prior quarters. The financial statements were restated for the following items:
>
> - Reversal of revenue recognized on as a one-time sale of software technology rights.
> - Reversal of a purchase of software technology and related amortization.
> - Accrual of a royalty liability and related recognition of royalty fees.
> - Recognition of amortization of debt discount.
> - Capitalization and amortization of beneficial conversion interest charges.
> - Capitalization of legal fees related to acquisitions.
> - Reclassification of impairment of prepaid development expense.
> - Reclassification of a gain on debt forgiveness from extraordinary item to other income.
> - Record fair value of stock options assumed at acquisition.

This laundry list of errors suggests Island Pacific has several material weaknesses in internal controls, yet the company management certified "all controls were effective"[38] with the filing of the amended 10-K/A. Interestingly, Island Pacific's board chairman, who also sits on the audit committee, is a "Chartered Accountant."[39] The company president and CEO is a "Certified Public Accountant and a former head director[40] of Ernst & Young."

[38] Island Pacific, Inc. SEC Form 10-K/A for the year ending March 31, 2004 filed on November 15, 2004 – "Based on their evaluation, our principal executive officer and principal financial and accounting officer have concluded that our disclosure controls and procedures that were in effect on March 31, 2004 were effective."

[39] Island Pacific, Inc. SEC Definitive Proxy Form 14-A filed on July 14, 2004 – "Mr. Silverman is a Chartered Accountant (South Africa) and has an M.B.A. from Stanford University. Mr. Silverman is a member of the Audit and Compensation Committees."

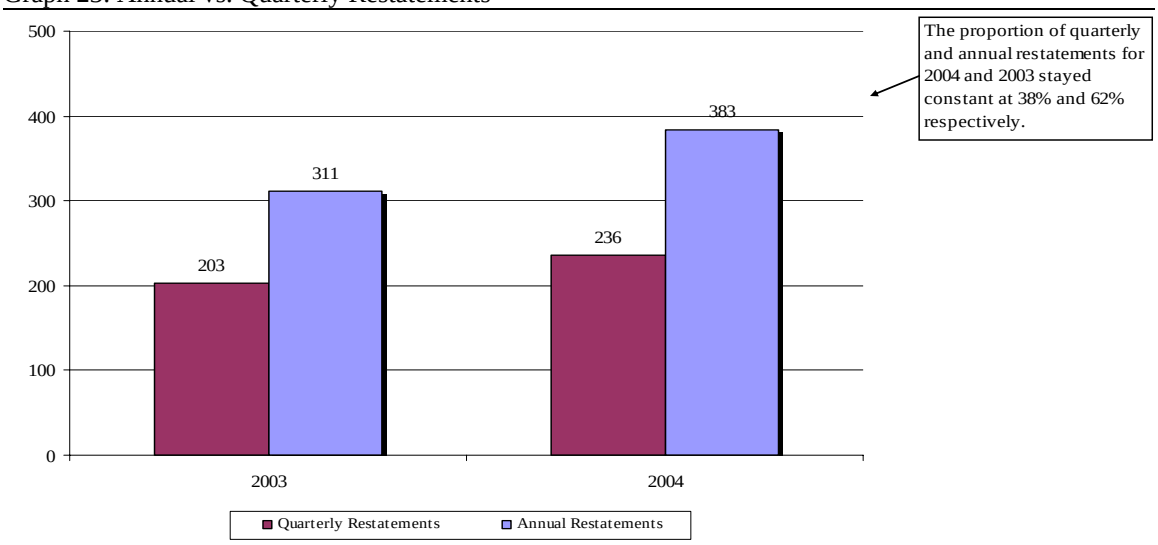
[40] Island Pacific, Inc. SEC Definitive Proxy Form 14-A filed on July 14, 2004 - "Previously, Mr. Tomczak served as head director of Ernst & Young's Sacramento office's Entrepreneurial Services Group. Mr. Tomczak holds a Bachelor of Science degree in business administration from Western Michigan University and is a Certified Public Accountant in both California and Michigan."

Quarterly vs. Annual Financial Statements

An investor depends heavily on both quarterly and annual financial statements, yet quarterly statements are not audited by the company's independent public accountant. It has only been since 1999[41] that the SEC has required an independent public accountant review quarterly statements. The difference between an audit and a review is considerable. An audit opinion gives investors the highest level of assurance accountants can provide on a set of financial statements. A review, by contrast, provides only limited assurance the financial statements are in conformity with generally accepted accounting principles. During a quarterly review, an auditor performs analysis of the results and balances. Questions arising from the review are answered by management, but, if these responses appear reasonable, they are not required to be corroborated.

Given the higher level of accounting assurance an audit provides, it seems there should be fewer restatements of annual financial statements vs. quarterly statements. However, the opposite is true. Only 38% of 2003 and 2004 of restatements we reviewed were "quarterly only."[42] Graph 23 illustrates this point.

Graph 23: Annual vs. Quarterly Restatements



Source: Glass Lewis.

Failing the Transparency Test

Investors should be skeptical of company management when a restatement is not fully and accurately communicated. Given a restatement's negative impact on share price, it's reasonable to assume that some companies would be less transparent than others in communicating the relevant information to investors. There are several methods in which company management can reduce the visibility of a restatement. Among them:

1. Not announce the restatement in a Form 8-K.[43]

[41] Final Rule: Audit Committee Disclosure SED 17 CFR Parts 210, 228, 229, and 240 [Release No. 34-42266; File No. S7-22-99] RIN 3235-AH83.

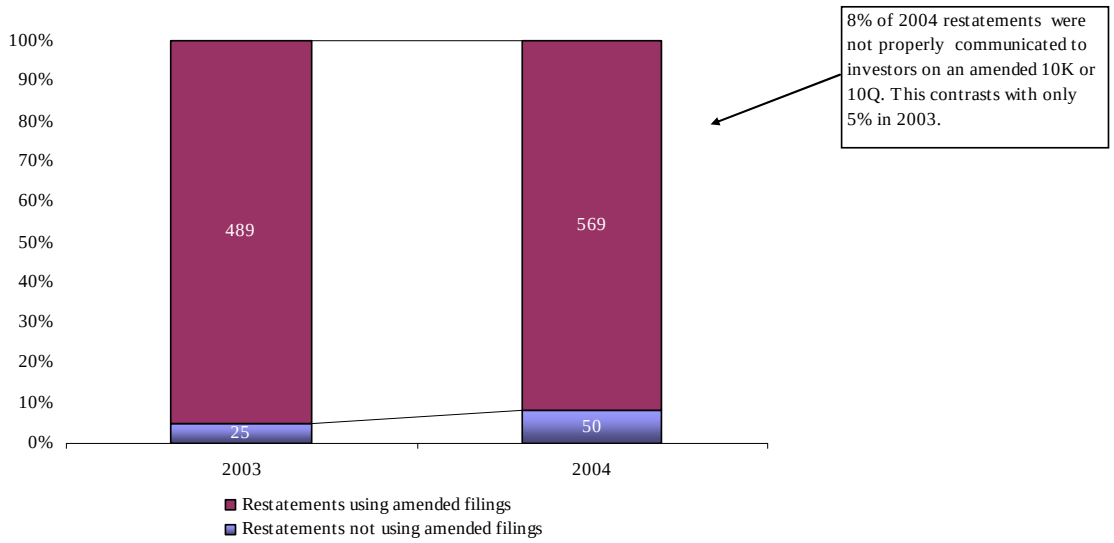
[42] If both annual and quarterly financial statements were being restated, the restatement was classified as an annual restatement. If quarterly only financial statements were being restated, the restatement was classified as a quarterly restatement.

[43] The SEC recently expanded the 8-K the number of events that are reportable on Form 8-K to include non-reliance on previously issued financial statements. Securities and Exchange Commission Final Rule:409-1: Additional Form 8-K Disclosure Requirements and Acceleration of Filing Date, Effective Date: August 23, 2004.

2. Not file amended Forms 10-Q or 10-K, but "bury" the restated results in the regular quarterly or annual filings.
3. Craft restatement language that doesn't use identifying words such as error, mistake or correction.
4. Use wording such as "adopt" or "apply" in reference to pre-existing accounting literature.

Graph 24 illustrates that the percentage companies that file restatements without using amended filings has increased from 5% of total restatements in 2003 to 8% in 2004.

Graph 24: Number of "Obscure" Restatements



Source: Glass Lewis.

In order to further obscure a restatement, company management will occasionally use language that insinuates the restatement is a voluntary action taken in order to remain current with ever-changing accounting rules – even if the accounting rules have been in existence for many years. The following disclosure given by Service Corporation (Service) is a classic example of restatement language that we think misleads investors. Note in this case a 2004 10-K/A was not filed. The prior year's restated results were buried in the 2004 Form 10-K. (bold-face emphasis added.)

> Service Corp. International (ticker: SCI) - "As a result of the adoption of SAB 101, we significantly changed our accounting procedures and controls to comply with the new revenue recognition accounting policies under SAB 101. ***Beginning in the latter part of 2000 and continuing through 2001 and 2002, we improved our procedures and controls for reporting the delivery of cemetery merchandise and performance of services. These improvements identified approximately $110 million of pre-need cemetery contract items that had been delivered or performed, but for which no revenues had been recognized.*** Previously, we recorded revenues associated with these pre-need cemetery contract items as changes in estimates in the period identified in our accounting system. Additionally, we also concluded that previously reported deferred revenues included approximately $41 million of items for which delivery or performance occurred, but revenue recognition had not occurred. ***Therefore, the restatement includes adjustments related to these two items affecting the cumulative effect of the adoption of SAB 101,*** revenues and deferred revenues from 2000 through 2003 to report cemetery merchandise and service revenues in the period these items were delivered or performed. "[44]

[44] Service Corp. International SEC Form 10-K for the year ending December 31, 2002 filed on March 15, 2004.

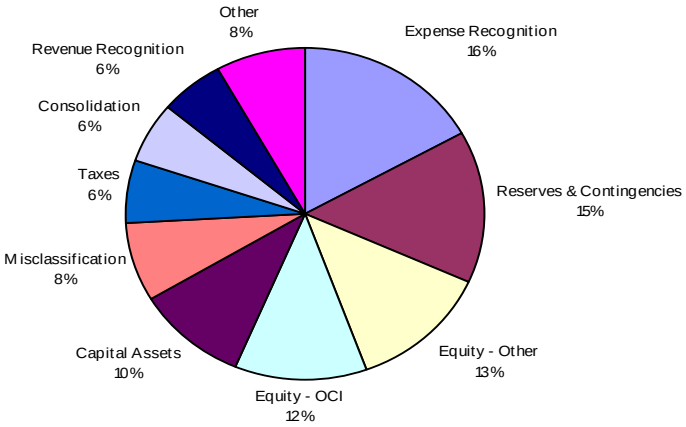
First, the SEC issued Staff Accounting Bulletin 101 (SAB 101), *Revenue Recognition in Financial Statements* in December 1999. SAB 101 was effective starting the fourth fiscal quarter for fiscal years beginning after December 15, 1999. In other words, if Service management was really adopting SAB 101, they were more than three years late. Second, we cannot comprehend why a company would take nearly four years to "**improve procedures and controls"** to a point where they could document a $151 million restatement.

An Overview of Foreign Restatements

We also analyzed certain 2003 and 2004 foreign restatements. In our query of the SEC EDGAR database, we searched for 2003 and 2004 SEC annual Form 20-F/A and 40-F/A filings that contained the terms "restate," "restatement" and "restated." We also identified some additional foreign restatements, mainly those not filed on an "amended" return by utilizing Capital IQ. Due to the erratic nature of quarterly foreign filings, we focused solely on the annual filings and corresponding restatements for the foreign companies. Our search was not designed to identify interim filings. Given this limitation, the findings from the foreign restatements reflect a sampling of restatements and not the complete foreign filing restatement population. The number of foreign companies reporting restatements does not include restatements disclosed in international (i.e. non-20-F and 40-F) filings made with other than the SEC.

Our review identified 31 foreign company restatements in 2004 vs. 29 in 2003. The leading categories of errors identified in our study of foreign financial statements related to expense recognition, reserves and loss contingencies and errors relating to equity-other and equity-other comprehensive income.
Graph 25 displays each error category as a percentage of total errors identified.

Graph 25: Foreign Restatements by Accounting Error Category

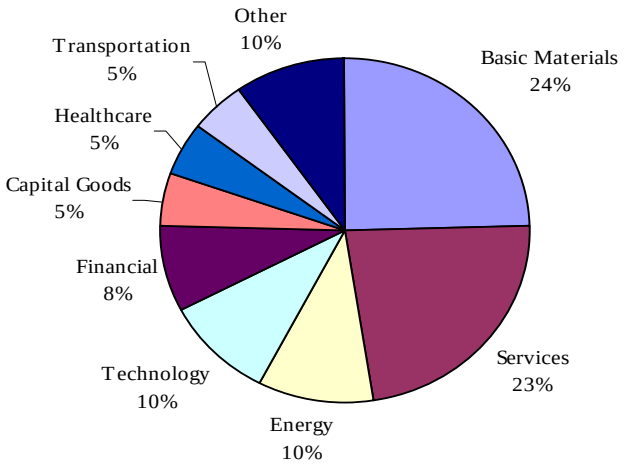


Source: FactSet, Glass Lewis.

Graph 26 illustrates the percentage of 2003 and 2004 foreign restatements by sector.[45] Nearly one in every two restatements was from either the basic materials sector, which includes mining and oil and gas companies, or from the services sector. The top four segments were basic materials (24%), services (23%), energy (10 %) and technology (10%).

[45] Appendix A provides a detailed listing of specific industries within each sector. Industry classifications provided by Reuters.

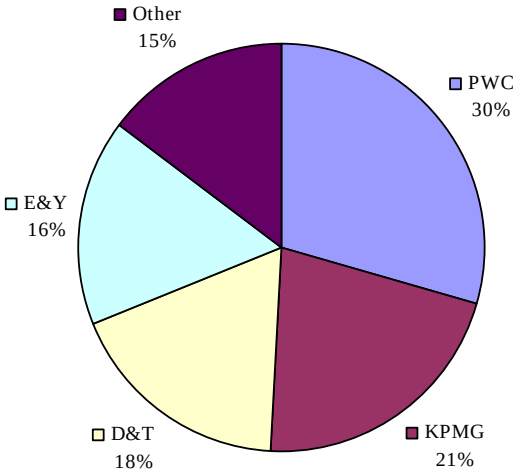
Graph 26: Foreign Restatements by Sector



Source: FactSet, Glass Lewis.

Graph 27 provides the percentage of total 2003 and 2004 foreign restatements summaries by auditor. More than 85% of the foreign restatements we reviewed were audited by a Big Four firm.

Graph 27: Foreign Restatements by Auditor



Source: FactSet, Glass Lewis.

February 15, 2005

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GLASS LEWIS & Co.

YELLOW CARD
TREND ALERT

Auditor Turnover Gains Momentum in 2004

Over 2500 companies have changed auditors in just the last two years. Arguments against changing auditors have fallen by the wayside as 1609 companies changed auditors in 2004 compared to 905 we identified in 2003. It appears as if rotation of auditors is occurring on a much more regular basis today. Our analysis of these changes reveals the following major issues for 2004:

- **Inadequate disclosures** by companies. In 2004, 947 companies, or 59%, did not disclose a reason for changing auditors, compared to 630 companies, or 70%, in 2003. Investors should remain skeptical as to why so many auditor changes are occurring without the real explanation for the change.

- There was a significant increase, from 58 in 2003 to 102 companies in 2004, in companies reporting their internal controls were inadequate. This was despite an earlier requirement that the Chief Executive Officer and Chief Financial Officer disclose such weaknesses beginning in August 2002. Small companies (under $25 million in revenue) accounted for 48% of those with control problems. Some of the larger companies reporting internal control problems were **Federal National Mortgage Association (Fannie Mae)**, **Symbol Technologies**, **Blyth Inc.**, **Network Associates** and **Pegasus Communications**.

- Of the companies reporting changes in auditors, 558, or 35%, reported going concern problems. This compares to 29% in 2003. A company does not receive a going concern opinion from its auditors unless they believe the company may not avoid bankruptcy for the next twelve months. What should be of interest to investors is that 92% of the 558 registrants receiving a going concern report were small companies. These obviously carry a much greater risk and investors should require a higher return in exchange.

- Non Big Four auditors gained market share in terms of absolute numbers. Big Four firms had a net loss of 400 audits, as they gained 164 while losing 564. Second tier firms had a net gain of 117 audits, as they lost 116 and gained 233. All other accounting firms gained 1146 audits while losing 929, for a net gain of 217.

- Big Four firms continued to remove smaller companies from their client list. The Big Four were dropped as auditors for 357 companies with less than $100 million in revenues while picked up for only 77 audits of such companies. However, 46 of the 53 companies with revenues greater than $1 billion changing auditors had previously been audited by a Big Four firm. Of these companies, 32 picked another Big Four firm as the replacement.

- Thirty companies reporting auditor changes **restated financial statements**. This compares to 14 last year. Over half of these companies also had internal control weaknesses. Of these companies, 16 had revenues under $25 million. Some notable companies in this category are **Network Associates**, **Bay View Capital Corporation** and **Fannie Mae**.

- Companies disclosing **disagreements with their auditors over accounting or auditing matters** decreased to 19, from 27 in 2003. Companies with revenues under $25 million accounted for eight (42%) of these disagreements. Larger companies in this category include **Symbol Technologies**, **Blyth Inc.**, **Meritage Corporation** and **Dentrite International Inc**.

- Nineteen auditors concluded they could no longer rely on management representations, compared to six in the previous year. Small companies accounted for nine (47%) of these non-reliance disclosures. Notable companies include **Molex Inc.**, **Glimcher Realty Trust**, **Lumenis Ltd** and **Falcon Products**.

Important disclosure information at end of report.

- Fifty-five companies cited fee reductions as their motive for changing auditors. This compares to 23 the previous year. Of these companies, 22 (40%) had revenues under $25 million. Major companies in this category include **Huntington Bancshares Inc.**, **Freds Inc.**, **Standard Motor Products,** and **Knight Transportation**. In our opinion, changing auditors solely to reduce fees may result in a reduction of audit quality.

- There was an increase in the number of changes due to the inability of accounting firms to meet, or a decision not to meet, SEC requirements for auditing public companies. We found 133 such changes, compared to 57 in 2003.

- There was a rise in the number of changes due to accounting firm mergers. We found 83 such changes, compared to 22 in 2003.

Analysis

Companies continued the upward trend in auditor changes in 2004, with over 1600[1] companies making the switch. Over 2,500 companies have changed auditors in just the last two years. Investors should continue to focus on what led to the change and whether this is an indicator of a potential negative impact on shareholder value. In addition, we note that 59% of the companies provided no explanation to their shareholders of the reason for the change, leaving them in the dark.

A change in auditor sometimes provides insight into a company's financial statements and may also provide an indication of the quality of the audit. Under Securities and Exchange Commission (SEC) rules, companies are required to disclose certain information when they change auditors. (See appendix A for disclosure requirements.) This disclosure can provide the first glimpse into potential problems in a company's financial statements. However, companies do not have to disclose a specific reason for an auditor change in order to comply with SEC rules. In these cases, investors are often left to wonder about the real reason for the auditor change. As indicated above, companies do not disclose a reason for the majority of auditor changes. Investors should always be cautious when a company announces a change in auditor, as it may be related to underlying problems in the company's financial reporting and accounting practices. These are some aspects of a company's disclosure that we believe can provide investors with insight into its financial reporting and accounting practices:

- Whether the company or the auditor terminated the relationship;
- The type of opinion issued within the past two years;
- Any disagreements in accounting principles;
- Any internal control weaknesses or deficiencies. Investors should also look for any reference to the company's ability to meet Sarbanes-Oxley 404 (SOX 404) requirements;
- Auditors inability to rely on management's representations;
- Reference to illegal acts;
- Any prior consultation with the new auditor as to accounting principles or the type of audit opinion that might be issued;
- Whether the auditor agrees with the company's statements about its termination in its SEC response letter.

[1] We obtained our information by examining SEC Form 8-K Item 4.01 and Item 4.0 filed for 2004. In 2003 we obtained our information by searching SEC Form 8-K, Item 4 filings for "resigned," "dismissed," "terminated," and "ceased," in conjunction with "accountants," for effective dates of the initial termination between January 1, 2003 and December 31, 2003. We excluded changes from Arthur Andersen in 2002.

Focusing on these issues is likely to provide a better understanding of why an auditor was changed as well as insights into a company's state of affairs. It is often the case that companies attempt to hide the real reason behind an auditor change, and investors may have to read the disclosure carefully to "ferret out" the reason behind the change. We also note that the real reason may be disclosed in another filing before or after the actual 8-K auditor change filing. The auditor's response letter itself may not provide greater detail, as the auditors may be cautious for fear of lawsuits and to avoid controversy. In some cases the auditor's response may leave investors more confused than the company's statements. The result is that investors are left to decipher what really happened.

A breakdown of the 78% increase in auditor changes in 2004 reveals that companies with revenues greater than $100 million changed auditors 238 times, compared to 115 in 2003. As in 2003, companies with revenues under $100 million dominated the number of changes, with a total of 1371, or 85% of total changes, compared to 790 (87%) in 2003. Big Four firms[2] accounted for 564, or 35%, of auditor changes in 2004. Tier Two firms[3] accounted for 116, or 7%, while other firms accounted for the remaining 929, or 58%. This is consistent with 2003, when the percentages were 36%, 9% and 55%, respectively.

Of the Big Four and Tier Two firms, BDO Seidman had the greatest number of wins with 109 new clients, followed by Grant Thornton with 80 and Deloitte & Touche (D&T) with 68. Conversely, Ernst & Young (E&Y) lost 200 clients, followed by PricewaterhouseCoopers (PwC) with 138 and KPMG with 125.

Reasons for Auditor Changes

There are a number of circumstances that might lead to a company and its auditor ending their relationship. When a company chooses to provide a reason, we believe investors should mainly be concerned about the following: "internal control weaknesses," "restatements," "disagreements on accounting," "inability to rely on management," "scope limitation," "unauthorized opinion," or "illegal acts." These types of reasons may point to deficiencies in a company's accounting function, and may ultimately impact the reported financial results. Investors should also be concerned about "independence impaired" and "cost reductions," as these could have implications for the quality of the audit both before and after the change.

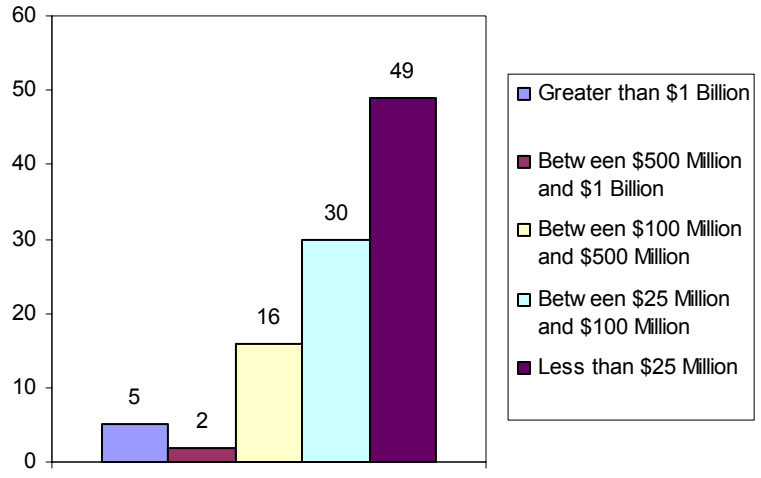
Internal Control Problems

Effective internal controls are necessary for both management and investors to obtain reliable financial information. Internal controls go a long way to preserve the integrity of an entity's financial reporting system. Without good internal controls, it is likely that management will make faulty decisions, due to unreliable data. For the same reason, investors will not be able to adequately analyze a company's financial statements and make the right investment decisions. Underscoring the importance of reliable financial reporting internal controls, SOX 404 mandates that a company's management assess the effectiveness of these internal controls and that the auditors attest to, and report on, this assessment made by management. We believe this will enhance the quality of companies' internal controls and the reliability of their financial information.

Since 1977, all SEC registrants, including small companies, have been required to maintain adequate internal accounting controls. Those controls should provide reasonable assurance that the financial statements have been prepared in accordance with GAAP. Chart 1 shows the types of companies reporting material weaknesses in their internal controls.

[2] According to Public Accounting Report's "Top 100 for 2004: America's Largest Public Accounting Firms," Big Four firms are Deloitte & Touche, Ernst & Young, PricewaterhouseCoopers, and KPMG.
[3] According to Public Accounting Report's "Top 100 for 2004: America's Largest Public Accounting Firms," Tier Two firms are McGladrey & Pullen, Grant Thornton, BDO Seidman and Crowe Group.

Chart 1: Internal Control Deficiencies by Company Revenue



Source: Company Reports, FactSet, GLC.

As the chart shows, investors have a greater risk that smaller companies are not maintaining adequate controls required by law. This finding is consistent with our 2003 report. Of companies with revenues under $25 million, 49 reported internal control problems. This represents 48% of all companies reporting internal controls problems, and compares to 25 (43%) last year. Companies with revenues between $25 million and $100 million were again the second most likely group. Of these companies, 30 (29%) reported internal control problems, compared to 18 (31%) last year. Two companies with revenues between $100 million and $500 million, and five companies with revenues greater than $1 billion, had internal control problems compared to one and six such companies in 2003, respectively. These figures indicate larger companies are more likely to have more efficient internal control systems. This is intuitive, as larger companies usually have more financial resources to implement and maintain proper internal control systems, and are able to attract better quality financial personnel.

The total number of companies reporting internal control problems increased from 58 in 2003 to 102 in 2004, a jump of 76%. This increase may be related to the impending deadline for SOX 404 compliance by accelerated filers,[4] as auditors may apply greater scrutiny in their audits before issuing a clean opinion on internal controls effectiveness. Given that small companies do not have to comply with this Act until July 2005, it may also be indicative that yet another waive of such disclosures is forthcoming in the upcoming year. As auditors were not specifically required to issue opinions on management's reports on internal controls in the past, it is likely there were weaknesses that were not reported by management. However, the new rules require the auditors to give their independent opinions on the statements made by management to the shareholders.

On average, the stock price decreased less than 1% in 2004 for those companies with revenues greater than $100 million who reported a material weakness in internal controls, in connection with a change in auditors in 2004. The stock prices of companies with revenues less than $100 million had an average decrease of 1.8% in 2004. This compares to the increase for the S&P 500 of 9%.

As SOX 404 takes effect, we believe companies will eventually correct their deficiencies in internal controls with fewer reported deficiencies. In the next few years, we believe SOX 404 will lead to improved internal controls and more reliable financial information being provided to investors.

[4] For accelerated filers (U.S. companies with market capitalization of $75 million or greater), the new rules are effective for fiscal years ending on or after November 15, 2004. Non-accelerated filers and foreign private issuers have until fiscal years ending on or after July 15, 2005, to implement the standard.

Table 1: Internal Control Problems at Companies with Revenues Greater than $100 Million

Ticker	Company	Predecessor	Successor	Summary of Internal Control Problem (*as Reported*)	Revenues *$ millions*
ACRS	Acceris Communications	PwC	BDO Seidman	Controls and procedures not effective to record, process, summarize and report information.	136
ACTU	Actuate Corp	Ernst & Young	KPMG	Detection of side letters and the process of investigating customer assertions regarding terms not specified in the agreements.	104
ALOYE	Alloy, Inc	KPMG	BDO Seidman	Absence of appropriate reviews and approvals of transactions, accounting entries and systems output at a subsidiary. Inability of accounting personnel to properly apply accounting pronouncements related to goodwill, intangible assets and other long-lived	372
ANR	Annuity & Life Re Holdings LTD	KPMG	Marcum & Kliegman	Segregation of duties (CEO and CFO roles performed by same person), inadequate review process and complicated accounting process.	226
BDC	Belden CDT	Deloitte & Touche	Ernst & Young	Lack of proper accounting resources at the corporate level and oversight of the accounting and financial reporting process.	485
BTH	Blyth Inc	PwC	Deloitte & Touche	Evaluation of changes in circumstances, internal reporting and management structures for compliance with FAS 131 and FAS 142.	1,506
BVC	Bay View Capital Corp	Deloitte & Touche	Grant Thornton	Lack of qualified accounting personnel and insufficient supervision resulting in incorrect amortization of premiums paid, origination fees and direct costs of auto installment contracts held for sale .	303
FNM	Fannie Mae	KPMG	Deloitte & Touche	OFHEO's determination of internal control weaknesses, application of FAS 91 and FAS 133, and financial statement close process.	53,768
FTSTQ*	Footstar Inc	KPMG	Amper, Politziner & Mattia	Numerous material weaknesses.	2,300
ION	Ionics	PwC	KPMG	Lack of qualified accounting personnel, controls to prevent or detect material accounting errors, timely collection and reporting of financial and operating data .	347
MWP	MarkWest Hydrocarbon Inc	PwC	KPMG	Reporting of hedge transactions with related parties.	208
MFE	Network Associates Inc	PwC	Deloitte & Touche	Booking of international subsidiaries' deferred revenue and making manual journal entries.	936
OCA	Orthodontic Centers of America	Ernst & Young	PwC	Financial statement close process.	375
PAGI	Pemco Aviation Group Inc	Ernst & Young	Grant Thornton	Lack of appropriate analysis and support for revenue recognition matters, contract estimates, inventory accounting, and reconciliation of intercompany transactions. Problems due to a lack of accounting personnel with appropriate experience.	190
PGTVE	Pegasus Communications	PwC	Not disclosed	Accounting for income taxes and equity method investments.	863
RCNCQ**	RCN Corp	PwC	Friedman LLP	Material weaknesses surrounding the training of existing personnel in the use of accounting software, which resulted in a material understatement of depreciation expense.	485
REMC	Remec	Ernst & Young	Squar Milner Reehl Williamson	Lack of review and technical accounting oversight of the financial statement close process; lack of timely reconciliation of bank statements and the lack of preparation, review and documentation of reconciliations for certain other accounts; inability of financial information systems to prepare a mechanized calculation of inventory reserves; inconsistency in application of policies and procedures relating to revenue recognition and payroll; inadequate documentation and analysis for foreign currency translation and exchange activities; inadequate segregation of duties and controls at a foreign subsidiary relating to cash, and timely accrual of liabilities.	385
SBL	Symbol Technologies Inc	Deloitte & Touche	Ernst & Young	Inadequacies related to the following: decentralized accounting structure, policies and procedures for identifying non-standard transactions, hiring of qualified and experienced personnel, training and supervision of personnel, systems and interfaces, processing of stock option exercises, revenue recognition, timing and recording of reserves, manual journal entries and account reconciliations.	1,530

Table 1: Internal Control Problems at Companies with Revenues Greater than $100 Million (cont'd)

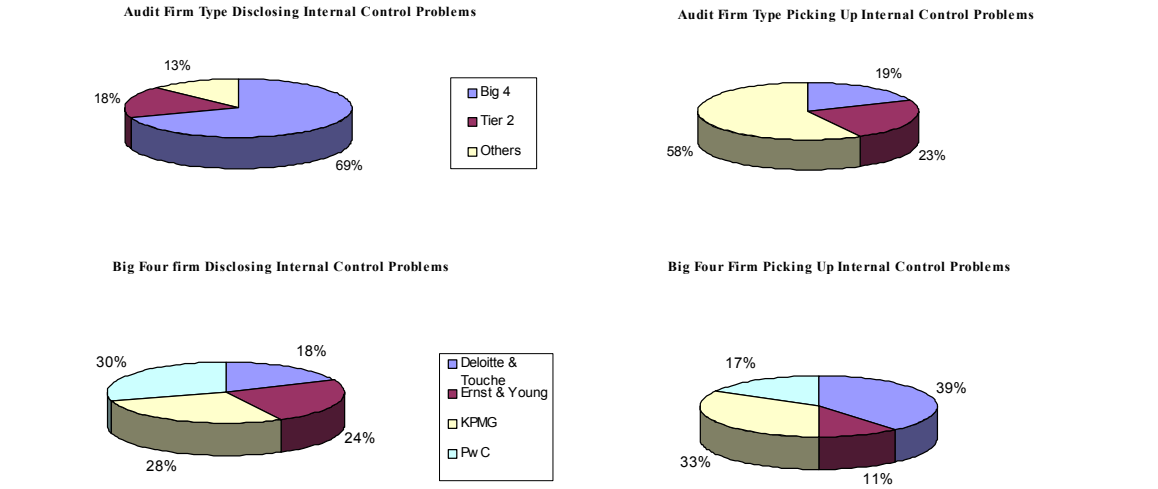
Ticker	Company	Predecessor	Successor	Summary of Internal Control Problem (*as Reported*)	Revenues *$ millions*
SCY	The Sports Club Company	KPMG	Stonefield Josephson	Application of new accounting principles or the application of existing accounting principles to new transactions. Improper accounting for private training revenues, management arrangement, goodwill and accretion of dividend on preferred stock.	133
SEIEQ***	Seitel Inc.	Ernst & Young	BKD	Applying certain rules for companies in bankruptcy.	131
TIER	Tier Technologies Inc	PwC	McGladrey & Pullen	Insufficient personnel resources and technical accounting expertise within the Company's accounting function.	128
TPR	Transpro Inc	PwC	BDO Seidman	Revenue recognition for sales with FOB destination shipping terms.	229
UPFC	United Pan Am Financial	KPMG	Stonefield Josephson	Processes for determining the adequacy of allowances for loan losses and inadequate resources in the Company's financial reporting and accounting departments.	101

Source: Company Reports, FactSet, GLC.
* Company filed for bankruptcy on March 2, 2004.
** Company emerged from bankruptcy December 21, 2004.
** *Company emerged from bankruptcy August 12, 2004.

The most common reasons for reporting internal control weaknesses appear to be personnel related. Reasons cited include lack of qualified accounting staff, insufficient segregation of duties, and lack of proper training and supervision. Another common problem is related to the inadequacies of companies' accounting information systems. All of these are important to the proper functioning of a company's internal control system and until they are at appropriate levels, companies are likely to continue to have these problems.

We also found that Big Four firms are most likely to identify internal control problems. These firms are also least likely to continue as auditors for a company after internal control problems were disclosed. This may raise questions as to whether smaller accounting firms are taking on increased risk.

Chart 2: Types of Audit Firms Involved with Internal Control Problems

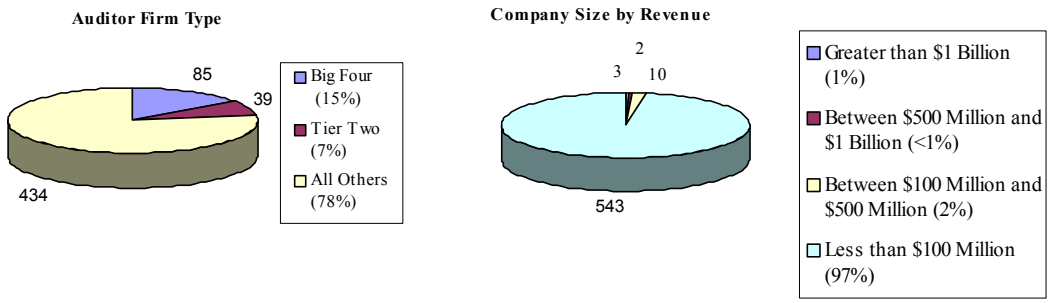


Source: Company Reports, FactSet, GLC.

Going Concern

A number of companies reported their auditor had provided them with a going concern opinion in their filings. A going concern opinion qualification indicates that the auditor believes the company is at risk of being unable to meet its financial obligations within the next twelve months and may have to cease operations. This should not be taken lightly, as it could lead to investors losing their entire investment in a company. Of the companies reporting changes in auditors, 558, or 35%, reported going concern problems. This compares to 266 (29%) in the previous year. The disclosures at the time of a change in auditors, regarding a going concern issue, refers to previous going concern disclosures already required by the SEC. Therefore, these disclosures should not be considered a surprise for investors. Often auditors may have resigned from these engagements due to a perception of increased risks. In cases where the auditors were fired, it may be that the company is displeased with the going concern opinion, and is in effect "shopping" for a more favorable opinion.

Chart 3: Going Concern Problems by Auditor Firm Type and Company Revenue



Company Reports, FactSet, GLC.

Restatements

Of those companies changing auditors, 30 restated their financial statements, compared to 14 last year. We believe restatements may be a sign of other problems in a company's accounting function. We observed that over half of the companies reporting restatements also reported internal control deficiencies. For these companies, the auditor changes all took place after the restatements, and appeared to be directly related. In eleven instances the auditors resigned, and in five the company dismissed them. In our opinion, the auditors may have perceived increased risks from these clients as a result of their internal control weaknesses, which may have led to their resignation. In cases where the auditors were dismissed, we believe the relationship might have been strained by the fact that the auditors uncovered weaknesses which led to the restatements.

Of the companies reporting a restatement, seven were audited by D&T, four by E&Y, seven by KPMG and five by PwC. Three were audited by second tier firms, and four by smaller firms. Seven of these companies, including **Network Associates**, **United Pan Am Financial** and **Fannie Mae**, were companies with revenues greater than $100 million.

For the companies reporting restatements with no material weaknesses, the auditor changes appear to be unrelated to the restatement. However, we believe that these companies may have had some form of internal control deficiency that led to the restatement, but they did not state the problem. If this is the case, in our opinion, investors might not have received full information about the state of the company's internal control system.

On average, companies who reported restatements saw their stock price decrease by 3% in 2004.

Accounting Disagreements

A public disagreement between a company and their independent auditor is likely to have a very negative and direct impact on the reported financial results. Disagreements are an indication the company is attempting to apply improper or aggressive accounting that the auditor is unwilling to accept and that fails to comply with Generally Accepted Accounting Principles (GAAP). A company will sometimes fire an auditor that disagrees with it, and subsequently hire a more "conciliatory" one.

Companies and their auditors are required to report disagreements on accounting matters, even if the disagreement is subsequently resolved to the satisfaction of the auditors. During 2004, 19 companies (or 1%) reported disagreements, compared to 27 (3%) in 2003. Six of these companies had revenues greater than $100 million, and five had revenues between $25 million and $100 million. Eight, or almost half, of those companies reporting a disagreement had revenues under $25 million, classified as "Small Business Issuers" by the SEC.

Table 2: Disagreement at Companies with Revenues Greater than $100 Million

Ticker	Company	Predecessor	Successor	Disagreement	CY Revenue *$ in millions*	Audit Fee	Non-audit Fees	Audit Fee % Revenue	Audit fee % Assets	Industry Audit Fee % Revenue	Industry Non-audit Fees % Assets
BTH	Blyth Inc	PwC	Deloitte & Touche	Requirements of FAS 131, *Disclosures about Segments of an Enterprise and Related Information.*	1,506	1.7	1.3	0.11%	0.14%	0.11%	0.12%
DRTE	Dentrite International	Ernst & Young	Deloitte & Touche	Revenue recognition policy used for the sale of certain irrevocable licenses. After discussion and review, the Company agreed with E&Y's proposed use of the "sell-through" method for revenue recognition.	321	1.1	0.4	0.34%	0.42%	2.62%	0.21%
MTH	Meritage Corp	KPMG	Deloitte & Touche	Information about entity formation, the absorbtion of expected losses and residual returns that a company must obtain in order to enable it to perform appropriate evaluations under FIN 46R. To date, the Company believes that it has implemented FIN 46R in accordance with KPMG's interpretations.	1,471	0.5	0.5	0.03%	0.05%	0.11%	0.12%
PAGI	Pemco Aviation Group	Ernst & Young	Grant Thornton	E&Y disagreed that an error was due to a mathematical mistake, and concluded that it was due to a change in estimate resulting from a change in assumptions underlying the workers' compensation reserve.	190	1.6	0.1	0.84%	1.52%	0.15%	0.16%
SBL	Symbol Technologies	Deloitte & Touche	Ernst & Young	Classification of certain 2002 investments. Dispute resolved by restating the Company's results in accordance with Deloitte's view.	1,530	3.4	10.6	0.22%	0.20%	0.29%	0.23%
SEIEQ *	Seitel Inc	Ernst & Young	BKD	Disagreement related to applying certain rules for companies in bankruptcy.	131	0.6	0.0	0.46%	0.16%	0.15%	0.05%

Source: Company Reports, FactSet, GLC.
* Company emerged from bankruptcy August 12, 2004.

We believe that strengthening the financial expertise of audit committees may reduce accounting disagreements, but it certainly will not eliminate them completely. Of the six companies above, three of them had Certified Public Accountants (CPAs) on their boards. **Meritage Corporation's** four-member audit committee had three CPAs, yet they still had an accounting disagreement with the auditor. On the other hand, the audit committee of **Molex** had no financial expert as defined by the SEC rules. As mentioned below in our non-reliance section, they had a litany of problems with the auditors. In our 2003 report, we highlighted the fact that the largest companies reporting disagreements all seemed to lack strong financial expertise on their audit committees.

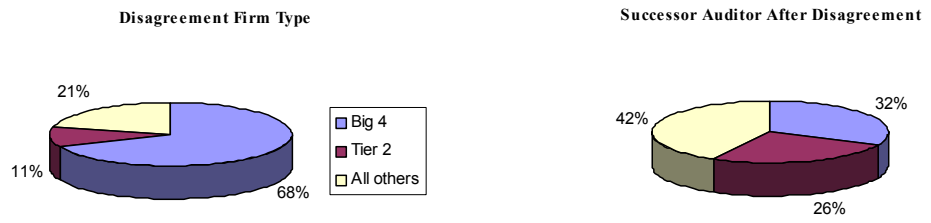
As in 2003, we found that Big Four firms were more likely to be involved in disagreements, and also less likely to be the successor firm after a disagreement. Of the 19 companies reporting disagreements, Big Four firms were predecessors thirteen times, or in 68% of the cases. Conversely, Big Four firms were successors six times, or 32%. The Big Four firms were also more likely to be successors in larger companies. This appears to confirm our

observation in our previous report that Big Four firms were more risk averse to becoming the successor auditor after a disagreement, especially among smaller companies.

Four of the 19 disagreements reported were related to revenue recognition problems. Apart from this, there was no significant pattern related to the reasons for disagreements.

On average, the six companies with revenues over $100 million in revenues who reported disagreements saw their stock price increase 4% in 2004.

Chart 4: Type of Audit Firm Associated with Disagreement



Company Reports, FactSet, GLC.

Non-Reliance on Management

Nineteen companies disclosed that their auditors concluded they could no longer rely on management representations for the purposes of conducting their audits. (See appendix B2 for a list of these companies and their auditors). This compares to six in 2003. Big Four accounting firms audited ten companies, three were audited by Tier Two firms with smaller accounting firms having audited six of the companies. This is consistent with our 2003 findings, where the larger accounting firms stated their unwillingness to rely on management.

We believe investors should be very concerned when an auditor is unable to rely on information provided by management. This casts doubt on the integrity of the financial statements, and of management. It raises a serious question as to the lack of oversight by the audit committee.

When an auditor is unable to rely on management, it means that something has occurred to cause the auditor to be suspicious with respect to the integrity of management and/or the board of directors. This may be the result of auditors learning that they have been provided with false or misleading information, or find that information has been withheld. In some cases, auditors refuse to rely on management because of actions not taken, such as proper investigation of improprieties. When D&T resigned as auditor for **Molex**, its response letter indicated a significant distrust between auditor and management. The auditor's lengthy response letter disagreed with most of the statements made by the Company in its disclosure. As a result of the auditor's concerns, the Company replaced its Chief Executive Officer (CEO) and Chief Financial Officer (CFO).

On average, the six companies with over $100 million in revenues who reported their auditor was no longer willing to rely on management saw their stock price increase 14% in 2004. **Lancer Corporation** went up 146%, while **Falcon Products** went down 95%.

Audit Scope Expansion

A request to expand the scope of an audit is usually an indication the auditor has uncovered a problem in the financial statements and needs to do additional work to arrive at a conclusion. This should concern investors, as it may impact the reported financial results. If an auditor's resignation or dismissal was related to a scope limitation, investors should be wary of the reported financial results. An auditor may have been fired to prevent further exposure or the auditor may have resigned to avoid any possible fallout. We noted only five companies that reported scope limitation in relation to an auditor change. (See appendix B3 for a list of these companies and their auditors). This compares to six in the previous year. This low level of scope limitations may indicate that auditors are being allowed to do their jobs and would therefore have a positive impact on financial reporting. On the other hand, it may be that auditors are not applying enough diligence in their audits, which would be a disservice to investors. However, the data does not allow us to determine the real reason for the low levels of audit scope expansion requests.

Three of the five companies, whose auditor indicated they needed to expand the scope of the audit, saw their stock price increase 30% in 2004.[5] One company, (**Isonics Corporation**), had their stock price increase from $1.17 to $5.49, a 369% increase. Their stock traded at $4.02 on the date they filed their Form 8-K announcing the change in their auditor.

Illegal Acts

Section 10A of the Securities and Exchange Act of 1934 mandates that auditors are to report potential illegal acts to the board of directors and audit committee. If the matter is not resolved in a timely manner, it must then be reported to the SEC in what is referred to as a "Section 10A letter." As we mentioned in our 2003 report, Section 10A letters are rare occurrences. Our research uncovered two companies, **Lancer Corporation** and **Rosedale Decorative Products**, where the auditors made reference to illegal acts in their SEC response letter. **Lancer Corporation** was subject to an SEC investigation in relation to the potentially illegal acts.

Unauthorized Opinions

Auditors sometimes withdraw their opinions for a number of reasons. Companies may take it upon themselves to file their reports with an audit opinion, although the auditors had not completed the work and had not given them permission to do so. In other cases, auditors sometimes uncover additional information after they had issued an opinion, and subsequently withdraw the opinion. We also found that, in most cases where an audit opinion is withdrawn, the companies had other accounting and auditing issues with the auditors. These issues usually included - accounting disagreements, scope limitations or material weaknesses. Sometimes these accounting issues delayed the audit, and companies may have issued these unauthorized reports to avoid late filing. Investors should be concerned when an auditor withdraws an opinion, as the auditor is saying he can no longer conclude that the financial statements are accurate. Audit committees are responsible for ensuring that companies are not issuing unauthorized reports.

We uncovered seven companies that issued reports with unauthorized audit opinions. We note that these were all small companies, and that all had other accounting and auditing issues with their auditors. In the case of **Industries International**, the company stated that it had received correspondence from the auditors indicating that the financial statements had been reviewed. In its response letter, the auditor asserted that the company's statement was "*factually incorrect and misleading*." When this happens, we believe investors should be concerned about the integrity of a company's financial statements and its management team, as well as the oversight of the board of directors.

[5] General Electric (GE) was one of the five companies reporting an audit scope expansion request. However, this was in relation to the audit of ITI's 401 K Plan. ITI was previously acquired by GE. We therefore did not include GE in the stock price comparison.

Audit Fee Reductions

Changing auditors in order to lower audit fees may result in lower quality audits, in our opinion. Of the 55 companies who disclosed that they changed auditors due to fee reductions (see appendix B4 for a list of these companies and their auditors), 33, or 60%, had been previously audited by Big Four firms, 9, or 16%, by second tier firms, and 13, or 24%, by small accounting firms. Of these companies, 5 ended up choosing a Big Four firm, 23 a second tier firm and 25 a smaller accounting firm. Two firms were still to name a successor. When a company discloses that it changed auditors for cost considerations, we believe investors should closely monitor the amount of audit fees disclosed in the subsequent proxy statement, to assess whether lower fees may have a negative impact on the quality of the independent audit.

Although few companies specifically mentioned increased costs due to compliance with SOX 404 requirements, we believe it may be a part of the reason for the increased number of changes related to cost reductions. Only one company, **Meridian Biosciences**, stated that it changed auditors due to increased costs related to auditing its internal controls. A few other companies also disclosed that they changed auditors to reduce costs related to SEC compliance. We suspect that these companies are also referring to SOX 404 requirements. In our opinion, companies that had poor internal control systems will find it more expensive to comply with SOX 404 requirements, as auditors will be required to perform more extensive testing procedures.

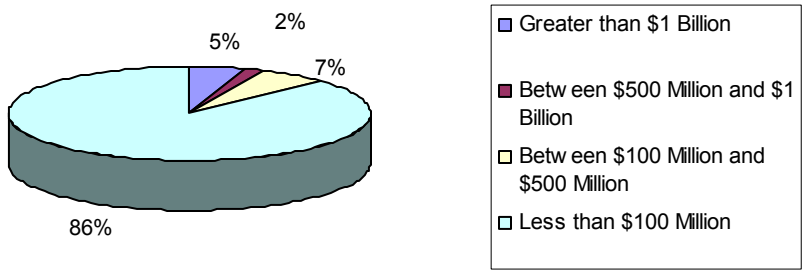
On average, the 55 companies who reported that they changed auditors in 2004 to reduce their audit fees, saw their stock price increase 33% in 2004. Only 23 of these companies reported a decrease in the price of their stock in 2004.

Opinion Shopping

Opinion shopping refers to the practice of changing auditors in order to get a desired opinion on an accounting matter, or the financial statements as a whole. This is usually evident when a company changes auditors frequently. In some cases, companies return to the same auditor they had recently dismissed. This might be an indication that the new auditor is not providing them with the desired opinion.

We found 61 companies that changed auditors at least twice during 2004. Of these, four companies changed auditors three times. These are **Biocoral**, **Xynergy**, **Income Opportunity Realty Investors,** and **Interactive MultimediaNetwork.** In the case of **Biocoral** and **Income Opportunity Realty Investors**, the auditors had difficulties with SEC registration requirements, which caused the companies to make changes. **Interactive Multimedia** changed from and then back to one of its former auditors. Most of the companies changing auditors more than once were small companies. Fourteen companies with revenues greater than $25 million changed auditors more than once.

Chart 5: Multiple Auditor Changes by Company Revenue



Company Reports, FactSet, GLC.

Auditors Resigning from SEC Registrants

We found 133 auditor changes related to SEC registration requirements for audit firms. In 2003 there were 57 such changes. Under Sarbanes-Oxley, auditors must register with the Public Company Accounting Oversight Board (PCAOB) in order to audit SEC registrants. About 70 small audit firms decided not to maintain either their registration with the PCAOB or some other requirements of the Act. Of these, 63 audited fewer than three SEC public companies. The highest number of companies audited by any one firm was nine.

It is extremely difficult for a small accounting firm, with limited resources, to stay up to date with the developments affecting public reporting companies. As a result, SEC enforcement actions often involve small accounting firms. Accordingly, it should not be a concern to investors that some companies are changing auditors as a result of their prior accounting firm's decision to no longer audit public companies.

It is also important to note that a greater number of audit firms who audit no public companies have taken the step of registering with the PCAOB. From public statements made by PCAOB staff, we understand that of the 1,415 PCAOB registered accounting firms, approximately 400 do not audit public companies. This suggests the benefits of registering with the PCAOB outweigh the related costs.

Firms may choose to register, as it increases their credibility in the eyes of potential clients. However, these companies are not subject to PCAOB inspections of their audits, because they do not audit public companies. In our opinion, these companies are benefiting from the reputation of a PCAOB registration without being subject to inspections of their audits. If these firms refer to their registration with the PCAOB, we believe it could lead to the public misunderstanding the level of oversight that has occurred.

Merger of Companies

Companies also change auditors as a result of changes in control or mergers. We believe investors should be less concerned about these changes, as they are due to the fact that the merged company needs only one auditor. Investors need only be concerned to the extent that the outgoing auditor discloses any information that might cast doubt on the company's financial reporting system. There were 102 auditor changes related to company mergers in 2004. Only two companies' auditors noted any material weaknesses in the last two fiscal years prior to their dismissal. We also observed that most of the companies had going concern problems, which might have prompted the mergers in the first place.

Merger of Accounting Firms

The number of changes related to audit firm mergers more than tripled from 22 in 2003 to 83 in 2004. The mergers of **Madsen & Associates** with **Sellers & Andersen, Chisholm & Associates** with **Bierwolf, Nilson & Associates,** and **Follmer Rudzewicz** with **Urbach Kahn & Werlin** resulted in most of the changes due to mergers in 2004.

Resource Constraints

We found ten cases, or less than 1% of auditor changes, where it was stated the auditor resigned due to resource constraints. Five of the changes involved the resignation of a small accounting firm, one a Tier Two firm and four involved Big Four firms. All incoming auditors were small firms, with the exception of two second tier firms. Only one of the ten companies had revenues greater than $100 million. We believe that these types of resignations are likely to increase, as auditors' workload increases due to companies somewhat belatedly implementing the requirements to have adequate internal controls.

Companies and Auditors – Which Are Changing and Which Are Being Changed?

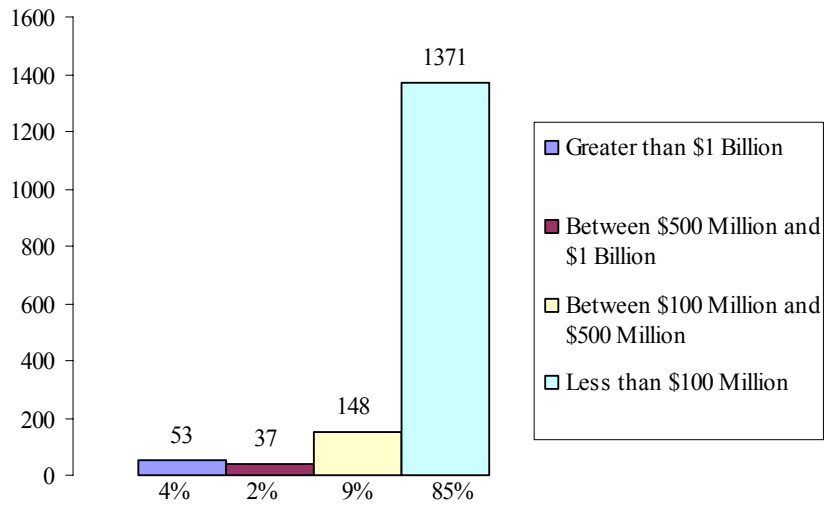
Consistent with our previous report, most auditor changes were among small companies. However, companies with revenues in excess of $1 billion changed auditors 53 times. This is more than double the 25 that made changes last year. In addition, companies with revenues between $100 million and $1 billion reported a change in auditors 185 times, compared to 90 in the previous year. Small company changes increased from 790 to 1371. As these numbers indicate, increases were prevalent in all categories.

Small companies account for a disproportionately high percentage of the auditor changes. Companies with revenues under $100 million comprise 53% of the FactSet database of SEC registered companies,[6] yet they account for 85% of auditor changes. Companies with revenues over $100 million comprise 47% of the FactSet database, while accounting for just 15% of auditor changes.

The accounting profession has long argued against mandatory rotation of auditors, stating that such a policy would reduce the quality of audits of public companies in America. However, given the recent level of changes in auditors that is occurring, either there are a large portion of audits whose quality is being negatively impacted, or as we suspect, the new auditors are getting the job done right for the audit committees that have now hired them.

[6] Companies in the FactSet database in terms of revenues are as follows: Greater than $1 billion 1906 (20%); between $500 million and $1 billion 787 (8%); between $100 million and 500 million 1866 (19%); between $25 million and $100 million 1763 (18%); under $25 million 3372 (35%).

Chart 6: Auditor Turnover by Company Revenue



Source: Company Reports, FactSet, GLC.

Of the 238 companies with revenues over $100 million changing auditors, 207 dropped Big Four firms and 13 dropped Tier Two firms. In 2003, Big Four firms gave up only 96 such clients, while Tier Two firms lost 9. However, only 87 (38%) retained another Big Four firm to replace the outgoing auditor. This compares to 64% retaining a Big Four firm in 2003. In contrast, 81 (35%) retained a Tier Two firm, and 63 (27%) retained a smaller firm. These figures compare to 20% and 16% retaining Tier Two and smaller firms respectively, in 2003. Seven companies have yet to name a successor.

For companies with revenues under $100 million, Big Four firms lost 357 clients (26%), compared to 227 (29%) in 2003. On the other hand, they gained only 77 small clients, or 6%. Tier Two firms lost 103 small clients, (8%) compared to 74 (9%) in 2003. Small audit firms accounted for 911 (66%) of small company changes. This compares to 489 (62%) last year.

Overall, Big Four firms had a net loss of 400 clients in 2004, compared to 201 in 2003. Small audit firms were the chief beneficiaries of this change, as they gained 217 clients in 2004, compared to 71 in 2003. Tier Two firms gained 117 clients in 2004, compared to 30 in 2003.

While the disclosures do not provide enough information to state definitively the reason for the change to smaller firms, we may put forward a number of possible reasons. One might be the fact that the Big Four firms are applying stricter guidelines in selecting their clients, a change they have stated publicly. This might have resulted in these firms ridding themselves of what they consider riskier clients (usually translated to mean smaller clients). A number of companies have also changed auditors in order to reduce their audit costs. In these instances, the data shows that companies are more likely to switch from a larger to a smaller firm. A third possibility is that a number of small firms have merged their operations, and have, therefore, become more competitive with some of the larger firms. While smaller audit firms increase their number of small audit clients, it appears that the largest companies will continue to rely on Big Four firms. Of the 90 companies with revenues over $500 million changing auditors, 52 (58%) chose a Big Four firm as a replacement. As we mentioned in our previous report, large companies tend to hire the Big Four to do their audit work, as CFO's often perceive them as the only ones who possess the resources necessary to audit many of these companies. An example is the recent selection of D&T to audit mortgage giant **Fannie Mae**. (See section below on **Fannie Mae's** auditor change.) When the company terminated KPMG, it chose Big Four firm D&T, who had previously advised its primary regulator, and avoided E&Y, who had previously advised the company on their accounting.

Overall, Big Four firms lost 35% of all audits, Tier Two lost 7% and other accounting firms lost 58%. At the same time, Big Four firms were successors 11% of the time, Tier Two firms won 15% of the audits and other accounting firms won 74%. The table below details the 2004 changes by auditors.

Table 3: Total Audit Firm Scorecard

Audit Firm	Predecessor		Successor		Net Gain/Loss
Deloitte & Touche	101	6%	68	4%	-33
Ernst & Young	200	12%	22	1%	-178
KPMG	125	8%	50	3%	-75
PricewaterhouseCoopers	138	9%	24	2%	-114
Big 4 Total	**564**	**35%**	**164**	11%	**-400**
BDO Seidman	38	2%	109	7%	71
Grant Thornton	63	4%	80	5%	17
McGladrey & Pullen	9	1%	28	2%	19
Crowe Group	6	0%	16	1%	10
Total Tier 2	**116**	**7%**	**233**	**15%**	**117**
All Other	929	58%	1146	74%	217
Grand Total	**1609**	**100%**	**1543**	**100%**	

Source: Company Reports, FactSet, GLC.
Note: Not all companies have disclosed a successor auditor.

Company Performance After Auditor Change

Does a change in auditor impact the performance of a company's stock? As one might expect, it depends on the facts and circumstances surrounding the change, and the company. Keep in mind that a significant majority of the companies disclosing a change in auditors did not state the reason for the change. They also did not disclose any financial reporting or disclosure issues.

As set forth in Table 4 below, we examined 82 companies with revenues greater than $100 million identified as having changed auditors in 2003. We found that 46 (56%) outperformed the S&P 500 by an average of 56 percentage points in the twelve months leading up to the date of the change, and 36 (44%) underperformed the S&P by an average of 32 percentage points. We also found that 25 (30%) underperformed the S&P 500 by an average of 16 percentage points the year after the change, while 57 (70%) outperformed the S&P 500 by an average of 121 percentage points the year after the change.[7] This suggests that investors view auditor changes positively.

As noted on page 4, those companies with over $100 million in revenues that reported a weakness in internal controls in 2004 saw their stock price decline on average less than 1%. However, after reporting a material weakness in internal control, companies may see an uptick in their stock price. Of the 11 companies that reported a material weakness at the time of a change in auditors in 2003, we found that 7 had an average increase in stock value of 80% a year after the change and 4 had an average decrease in value of 18%. Overall, these 11 companies had an average increase in stock value of 44% in their stock price after the change. For example, **Kmart** reported internal control weaknesses in 2003, but its stock price increased by over 200% a year after the auditor change.

[7] A number of companies outperforming the S&P 500 had very low stock prices, which magnified percentage increases.

Table 4: Company Performance After Auditor Change

Reasons for Auditor Change	Outperform S&P 500 Before Change	Underperform S&P 500 Before Change	Outperform S&P 500 After Change	Underperform S&P 500 After Change
Disagreement	1	4	4	1
Material Weakness	8	3	5	6
Restatement	1	2	3	
Non-reliance on management	0	1	1	0
Scope Limitation	0	1	1	0
Cost Reduction	4		4	0
Others	32	25	39	18
Total	**46**	**36**	**57**	**25**

Source: Company Reports, FactSet, GLC.

Impact of Auditor Changes on Audit Fees

Audit fees do not always decline when there is a change in auditors. We examined the audit fees of 38 companies with revenues over $100 million that changed auditors in 2003, before and after the change. We found an aggregate increase of $5 million in audit fees, an average of $0.13 million per company. This included 16 companies whose audit fees declined an aggregate of $21 million, or 49%. Twenty-two companies' fees increased an aggregate of $27 million, or 84%.

Audit related fees also declined by $5 million. Overall cost therefore remained the same. The increased audit fees may be due to the incoming auditors increasing fees for additional work necessary to increase audit quality such as for SOX 404 compliance. We attribute the reduction in other fees to the fact that companies are relying less on auditors for other services, as this may bring their independence into question.

Significant Auditor Changes in 2004

There were a couple of high profile auditor changes in 2004 that we believe, are worth individual mention. These highlight the need for proper auditor and audit committee oversight of companies' financial statements.

Fannie Mae's dismissal of KPMG is probably the most significant auditor change in 2004. A report by the **Office of Federal Housing Enterprise Oversight (OFHEO)** questioned the company's application of Financial Accounting Standard (FAS) 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*, and FAS 133, *Accounting for Derivative Instruments and Hedging Activities.* The SEC subsequently confirmed that the company had indeed applied the standards incorrectly. The company will restate its financial statements for the last three years, resulting in losses possibly in excess of $9 billion. The CEO and CFO were forced to resign as a result of the debacle.

Although it is management's responsibility to ensure that accounting standards are properly applied, auditors have a responsibility to provide an independent examination of the financial statements. As such, KPMG also played a key and pivotal role in ensuring the integrity of the **Fannie Mae** financial statements and disclosures. Due to the pending restatements that are expected to aggregate in the billions of dollars, a question arises with respect to the integrity, quality and independence of the examination performed by KPMG. We note that **Fannie Mae's** stock fell by 7% in one day when it disclosed the accounting irregularities.

Another significant auditor change in 2004 was **American Express**' dismissal of E&Y who had been the auditors for **American Express** since 1975. In 2003, the Company paid E&Y $23 million in audit fees and $3.5 million for other services. We believe the dismissal may have been related to an SEC investigation into whether E&Y violated auditor independence rules by entering into a profit-sharing agreement with the company's travel service

unit. The company did not make any reference to this investigation in its auditor change disclosure. This investigation was part of a larger one by the SEC into E&Y's auditor independence compliance procedures. E&Y was subsequently barred from accepting new clients for six months, based on the outcome of the findings. The company's stated reason for the auditor change is that its Audit Committee Charter required it to review its external auditor every ten years. We note that the company did not publicly disclose such information until 2004. In our opinion, this raises questions as to whether this was the reason for the change, or whether it was done to provide a smoke screen for the real reason behind the change.

Conclusion

Disclosures regarding changes in auditors may provide investors with a useful glimpse into the state of a company's financial reporting system. We believe investors need to pay close attention to these disclosures, as the impact on a particular company's stock price is company and fact specific.

The number of changes in auditors in 2003 and 2004 has escalated significantly, aggregating over 2500 companies. A growing percentage of audit committees, who now must hire and fire auditors, have chosen to make a change. This is inconsistent with arguments put forth in the past by the accounting firms, that changing auditors reduced audit quality.

In the current year, the number of changes in auditors in which a material weakness in internal controls was reported, or a company having a difficult time making it as a going concern, also increased significantly.

Small accounting firms were the winners of market share in 2004. While small accounting firms in general vehemently opposed the passage of SOX, it appears that in reality, they may be one of the largest beneficiaries of the Act. The larger firms appear to be more selective these days in accepting smaller companies to audit, perhaps as they typically involve much lower revenue and profit potential.

In our opinion, a major concern is the lack of adequate information in auditor change related filings. Companies provided no reasons for 59% of the changes in auditors in 2004. Accordingly, we believe the SEC should revise its rules to bring greater transparency to these changes.