# Special Report

*Restatements*

## Restatements Likely to Continue, Particularly for Smaller Companies

The number of financial restatements made by public companies is not going to go down and in fact will increase for smaller companies in particular as they phase in their Section 404 internal control reviews and their auditors undergo inspections by the Public Company Accounting Oversight Board, securities and accounting experts told BNA in recent interviews.

Former Financial Accounting Standards Board Chairman Dennis R. Beresford said he hopes restatements will not be as frequent in the future as they have been recently for larger companies. However, just as it could be difficult for smaller companies to keep up with the more technical issues in accounting, he told BNA July 14, "Even the largest companies might find something was not done, mainly because things are so complicated."

Charles R. Drott, a certified public accountant and fraud examiner in San Francisco and a member of the California Board of Accountancy, told BNA July 8 the restatements made by public companies in recent years are "a continuing and growing killer of investor confidence in corporate America," and corporate financial reporting is in a state of crisis.

The costs of these restatements are "simply devastating" to investors and to Wall Street, Drott, speaking on his own behalf and not for the CBA, said. "When a large public company reports a financial restatement, there is typically a massive drop in its stock price and resulting loss in its market capitalization in the hundreds of millions or billions of dollars. When that happens, usually what follows is costly, protracted civil litigation and, in some cases, criminal prosecution."

**Multi-Year Upward Trend Noted.** According to Huron Consulting Group's March 2005 annual review of financial reporting, financial restatements have continued to grow over the years from 158 restatements in 1998 to 414 in 2004. Huron reported that in 2004 alone, there was a 28 percent increase in financial restatements.

Huron also found that in 2004, 15 percent of the restatements were filed by repeat registrants. According to Huron's report, there was "a rising trend in the number of periods contained in each restatement," which shows "recurring flaws in accounting policies, practices, and errors."

Emphasizing the magnitude and meaning of these numbers, Drott said, "In many instances, a financial restatement is an admission by corporate management that there are material errors or fraud in a company's previously issued financial statements which renders them unreliable and misleading to investors and others who have read and relied on them."

Based on the significant number of accounting fraud cases in which Drott has testified as an expert witness, he said fraudulent corporate financial reporting—primarily through improper revenue recognition practices and earnings manipulation—continues to be the leading cause of financial restatements.

**PCAOB Inspections Can Uncover Errors.** The causes of the rise in restatements are multiple. One is the Public Company Accounting Oversight Board's limited inspections of the Big Four accounting firms last year, which uncovered problems that led to financial restatements for larger companies (2 CARE 920, 08/27/2004).

For example, Beresford, who is an accounting professor at the University of Georgia and chairman of the Kimberly-Clark, Legg Mason, and MCI audit committees, said the PCAOB found one audit firm failed to comply with the provisions of Emerging Issues Task Force (EITF) No. 95-22, *Balance Sheet Classification of Borrowings Outstanding under Revolving Credit Agreements that Include both a Subjective Acceleration Clause and a Lock-Box Arrangement*, and identified other firms that were having the same problem.

In the end, he said, they identified the issue at 20 to 25 companies, and several had to restate their financials. "So to the extent something is identified in one of the PCAOB inspections, the PCAOB has a system to alert the rest of its inspectors," he said.

Financial restatements for smaller companies should similarly increase because the PCAOB's inspectors for the first time this year are looking at smaller audit firms, which for the most part audit smaller public companies, Beresford said.

Pointing to the PCAOB's recently issued reports on their inspections of smaller audit firms, Beresford said, in almost every case the PCAOB found problems that indicate there would be some sort of restatement. "It looks like it is almost universal" for the PCAOB to challenge something done by the smaller accounting firms, he said.

It is likely that over the next few months there will be quite a few more PCAOB inspection reports presaging more restatements

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ahead, he went on to add, noting, "There are a lot of smaller companies out there."

**SEC Pronouncements Cited as Another Cause.** Another trigger for restatements is Securities and Exchange Commission pronouncements on new views on accounting, according to corporate and securities attorney Brian Lane. These pronouncements are "new" in the sense that the accounting standards have not changed, but the SEC is providing new guidance, Lane, a former director of the SEC's Corporation Finance Division now with Gibson, Dunn & Crutcher LLP in Washington, D.C., told BNA July 15.

Last year, for example, the SEC's new guidance on lease accounting caused dozens of companies to restate their financials. Lane said these changes can happen routinely.

Beresford said he hopes restatements will not be quite as frequent going forward for larger companies. "Obviously, there were a large number of restatements on the lease accounting issue, but I'm not aware of anything like that that has been identified this year." On the other hand, he said it may not be out of the question, noting General Electric's recent issues with derivatives accounting.

**Section 404 Compliance.** Another reason for the rising trend in the number of restatements is Sarbanes-Oxley Act Section 404 compliance. Section 404 requires companies to review and report on the health of their internal controls over financial reporting. Smaller companies have had the benefit of a delayed implementation date for Section 404 and related rules, but larger public companies had to comply this year with the internal control review requirements.

It is too early now, but at this time next year, there likely will be "a spike in restatements as smaller issuers start complying with Section 404 as part of their July 26 phase-in," Lane said.

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**For accelerated filers, the Section 404 process "was very expensive, but it had the benefit of forcing large companies to go through their closets and fix any problems."**

BRIAN LANE
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"The events that drove restatements in the past year largely were the Section 404 internal control reviews of accelerated filers," Lane said. "As they went through their controls, they found mistakes. If they all added up to a material number, they had to restate."

For accelerated filers, the Section 404 process "was very expensive, but it had the benefit of forcing large companies to go through their closets and fix any problems," he said.

**Smaller Companies Rely on Small Audit Firms.** Another reason restatements may be more frequent for smaller companies is that they for the most part deal with smaller accounting firms and may not have the necessary expertise or resources to handle the more complex accounting issues, Cynthia Richson, corporate governance officer for the Ohio Public Employees Retirement System and a member of the Council of Institutional Investors' board, told BNA July 18.

Beresford similarly said most smaller companies have more limited resources, and many deal with smaller accounting firms. "It is just harder for smaller companies to keep up with the more technical" issues, he added, "so they will be challenged fairly often."

A recent study conducted by proxy research advisory firm Glass Lewis & Co. LLC, Broomfield, Colo., in fact reveals some statistics that "do not bode well" for smaller companies, Richson said.

According to Glass Lewis Managing Director of Research Lynn Turner, the Glass Lewis study found the error rates for companies and auditors working in the realm of a $75 million market cap and below is two to three times higher than companies at the top. "At the end of the day, the statistics show the error rates are significantly higher," Turner said at the PCAOB's June 9 standing advisory group meeting.

Noting the SEC recently created a new advisory committee to determine whether to ease the burden of Section 404 and other requirements for smaller public companies, Richson took issue with recent pushes to roll back corporate governance reforms for smaller companies in particular: "It is fine to say we are smaller companies and have special needs, but should that pass muster? There is a certain base line or floor of responsibility that you take on when you become a public company."

She went on to say, "I still think it is about the quality of the audit. We keep saying we need to restore investor confidence. Well, we still have work to do, and this is not the time to start going backwards. Let's finish the job."

In a similar vein, Drott said, "Financial restatements are a clear indicator of the failure of corporate management to meet their responsibility to accurately report the results of their operations, which is one of the most basic and fundamental obligations of corporations. The result is the undermining of investor confidence in U.S. capital markets caused by a loss of trust in corporate management and its financial reporting."

**Audit Committees Play Ongoing Role.** Audit committees, with their oversight role under SOX, should be involved both before and after a company's financial restatement by coordinating investigations, overseeing appropriate disclosures, asking about certain accounting issues that have proven to be problematic for other companies, prioritizing based on risk, and getting outside advice when needed, interviewees told BNA.

Audit committees will often make inquiries to make sure a mistake was the product of unintentional error rather than any misconduct, Lane said.

Further, most audit committee members, after seeing a situation like the one General Electric had with its derivatives accounting issue, would ask the companies they are working with whether they have any similar issues, Beresford suggested. "If nothing else," he said, "audit committees should ask the financial people to go back and look at what they have done."

Beresford said it "would not surprise" him if there are more corrections regarding FASB Statement No. 133, the 1998 standard on derivatives and hedge accounting, when a company like GE admits it had prob-

lems in applying derivative accounting rules following earlier restatements by mortgage finance companies Fannie Mae and Freddie Mac. "You have to believe other companies have applied Statement 133 in good faith, but if someone else takes a look, they may not have crossed all of the t's or dotted all of the i's," he said.

The good news, although it is "surprising," is there have not been more restatements resulting from this, he said.

Beresford said last year's lease accounting issue is another example (3 CARE 141, 2/11/2005). The issue came up with one of KPMG LLP's clients and they asked the SEC about it, which "resulted in sort of the water tap being turned on full blast," he said.

Speaking from an investor's perspective, OPERS' Richson said she has heard anecdotally from people sitting on corporate boards that accountants need to do a better job of prioritizing risk in the audit process so they are not just encouraging audit committees to throw money at audits generally. This issue of getting auditors to drop their checklist mentalities has been taken up by the PCAOB as well. Richson said audit committees and their auditors still are having a hard time with making the transition to a risk-based approach.

One of the things audit committees are supposed to do is arbitrate or mediate if differences of opinion come up between internal financial executives and outside auditors, Beresford said. So, hypothetically, there could be situations where companies and auditors are having those discussions, he said. Audit committees that need some extra comfort may want to bring in another accounting firm for consulting purposes, he added.

**Disclosure Issues.** Regarding disclosure issues associated with restatements, Beresford said, "In today's world, with SEC rules on disclosure of material events under Form 8-K, companies cannot sit on things like restatements." He went on to say if there was "a situation," a company would "want to pin it down very carefully and must identify it. Once the problem has been verified, they have to get the news out immediately."

In a similar vein, Lane said a company might take months to determine if a restatement is needed. However, once it determines a restatement is necessary, it must file a Form 8-K in four business days.

Richson said a key question is whether a company can have a financial restatement without disclosure of a material weakness in internal controls.

**Maintain Independence, Objectivity.** Drott said based on his own experience examining fraud, audit committees have been improving as a result of SOX requirements, but "they still place too much reliance on the company's independent auditors to assure the reliability of the company's financial reporting." In fact, he went on to say, in a lot of the cases for which he was an expert witness, audit committee members commented that they were just relying on their independent auditors.

However, he said, "Audit committees have the responsibility of direct oversight over the corporations' financial reporting. They need to take a deeper look and do more to ensure the financial statements comply with professional standards and fairly represent the financial results of the company. It goes beyond just the independent audit."

Independent auditors, in Drott's view, often "fail in their audits because they did not maintain their objectivity and confront corporate management for fear of

## Restatements Continue to Plague Software Industry

Charles R. Drott, a certified public accountant and fraud examiner in San Francisco, told BNA July 8 the software industry "is particularly egregious in its improper revenue recognition practices, which in turn causes a large number of financial restatements." He said he has seen all of the top 10 fraud schemes (3 CARE 305, 3/25/2005) in the software industry.

According to Huron Consulting Group's March 2005 annual review of financial reporting, over the past five years, the largest number of restatements were found in four industries:

- manufacturing,
- finance, insurance, and real estate,
- transportation, communications, electric, gas, and sanitary services, and
- software.

Drott said many of the cases in which he has testified as an expert witness have involved companies in the software industry. Huron in fact reported 203 restatements in the software industry in the last five years, which Drott called "a very alarming statistic."

Of the 51 financial restatements Huron reported in the software industry last year, 39 percent were because of improper revenue recognition. Drott said this is entirely consistent with the cases he has investigated. "It has been and continues to be a significant problem," he said.

Drott said accounting in the software industry is "extremely complex" and "companies are many times so aggressive in their revenue recognition practices that they violate the accounting rules." Prior to 1997, there was an accounting standard for software revenue recognition called Statement of Position (SOP) 91-1, which, because of its lack of specificity and the need for clarification, enabled corporate America and software companies to find many ways to manipulate their revenue recognition, he said.

The rules were tightened up in 1997 in SOP 97-2. However, Drott said, the revenue recognition practices in the software industry are still vulnerable to abuse because of the many different types of software contracts and deals, including revenue swapping schemes with customers, which many times violate the accounting rules.

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losing a large public company client and the related audit and consulting fees. Instead, far too often, the auditors cave in to management's wishes and attempt to rationalize improper accounting positions. In many other instances, the auditors attempt to rationalize that a financial misstatement is not material, when there is fraud involved."

Many restatements are the result of one of two things: either human error, when corporate managers make "a complete blunder in the application of accounting principles," or fraud, he said. Fraudulent financial reporting "will be solved only when corporate management decides to embrace a culture of honesty and integrity in financial reporting."

Looking forward, Lane said things should calm down. The larger companies still will restate their financials, but their restatements largely will be driven by inadvertent errors found as part of their year-end closings. He said calendar-year companies' restatements would occur in the first quarter, because they would have discovered issues in their closing audits. June 30 filers, on the other hand, may start finding problems now.

With regard to the PCAOB's inspections of audit firms, Lane said audit firms might go back and change their policies as a result of the inspections. However, he said, the SEC is the primary driver that, along with the Financial Accounting Standards Board, has the purview over the interpretation of accounting standards that might trigger restatements.

By Alison Carpenter