



Mark Grothe, Research Analyst
mgrothe@glasslewis.com, 303-532-2426
Ann Pham, Jay Saban, Research Assistants

Jonathan Weil, Managing Director
Editor of Financial Research
jweil@glasslewis.com, 303-532-2424

Getting It Wrong the First Time

A look at 2005's record-breaking year for corporate restatements shows why investors can't afford a return to pre-Enron securities regulation

Just when it appeared the numbers of erroneous financial reports by publicly traded companies couldn't get any higher, they once again have soared to record levels.

Companies with U.S.-listed securities filed 1,295 financial restatements in 2005, nearly double the previous year's mark. That's about one restatement for every 12 public companies—up from one for every 23 in 2004. Of these, 100 were by foreign companies. About the only thing rising faster is executive compensation. The burden of these errors, of course, falls on investors, who rely on companies' management to get the numbers right the first time.

But to hear a relative handful of senior executives and policy makers tell it, the big problem isn't that investors got bad information the first time; rather, it's that Congress overreacted when it passed its landmark Sarbanes-Oxley Act in 2002 and that, for the good of global capitalism, Congress now should relax the scrutiny it imposed on corporate boards and executives after the collapses of Enron and WorldCom. As we write this report, the Securities and Exchange Commission's Advisory Committee on Smaller Public Companies is recommending just that.

After surveying last year's accounting mishaps and do-overs, we couldn't disagree more. It's precisely because of the heightened auditing standards mandated by Sarbanes-Oxley that investors today are getting a true sense, finally, of just how much work remains to be done before they can feel confident about the accuracy of the financial statements prepared by corporate managers.

These restatements aren't just about revising subjective judgments or complying with esoteric, complex accounting pronouncements. In hundreds of instances, they stem from basic misapplications of simple rules or critical breakdowns in corporate controls and competencies. The good news is that, thanks to renewed urgency by auditors and their regulators, investors at least are getting better accounting (hopefully) on the next go-around. For that, they also can thank the renewed public-policy focus on the need to maintain strong internal controls.

Simply put, internal controls are the systems, checks and balances that companies must keep in place to ensure that their financial accounts are recorded and presented accurately. Careful scrutiny of these controls, through independent testing and reporting by outside auditors, is what Section 404 of Sarbanes-Oxley mandated. By and large, this testing is what uncovered the weaknesses

Restatements Scorecard

	2005	% of Public Companies
U.S.	1,195	8.5%
Foreign	100	8.1%
Total	1,295	8.4%

at the heart of the current rash of financial misstatements. Without this testing, we feel certain that investors still would be relying today on false financial statements at many of the thousands of companies that have restated their accounts over the past few years.

Last year's volume of restatements likely would have been even higher had U.S. regulators not agreed to make an exception for companies with stock-market values of less than \$75 million and extend their 404-compliance deadlines into 2007. As you'll see from this report's findings, the smallest companies are where strong internal controls arguably are needed most, because they are where the risk of restatement is the highest. Further, companies audited by the smallest accounting firms restated at six times the rate of other companies—a trend that begs for more frequent inspections of these firms by the Public Company Accounting Oversight Board.

Finally, make sure you take a close look at last year's surge in "stealth restatements." By this, we mean the companies corrected material errors—but they did so with minimum publicity, by quietly including fixes in their quarterly and annual reports, rather than using the 8-K disclosure forms that the SEC created expressly for announcing restatements. We believe this development would trouble any reasonable investor—and demands the immediate attention of regulators.

-- GLC

Key Findings

- 1,295 financial restatements—about one for every 12 U.S.-listed companies; nearly double the number in 2004, and a new record
- 1,195 restatements by U.S. companies, and 100 restatements by foreign private issuers with U.S.-listed stocks—both new records
- “Stealth” restatements on rise—14% of restatements filed without amended filings, 8-K filings or other public announcements
- Companies audited by the smallest audit firms were six times more likely to restate than companies audited by the Big Four
- The smallest companies, measured by market capitalization, were nearly twice as likely to restate as the largest companies
- Half of companies filing restatements still claimed to have effective internal controls over financial reporting
- Highest auditor restatement rate: Grant Thornton, 12%
- Highest Big Four auditor restatement rate: KPMG, 7.1%
- Lease-accounting errors were responsible for 249 restatements
- Hedge-accounting restatements: The next big wave?