



## 2004 Annual Review of Financial Reporting Matters

Huron Consulting Group is proud to present its *2004 Annual Review of Financial Reporting Matters*.

After the leveling off during 2003, financial restatement filings increased dramatically in 2004. There were numerous pressures and points of scrutiny at work in 2004 that gave rise to this increase, most of which were the result of the reforms set in motion by the Sarbanes-Oxley Act of 2002 (SOX).

Huron's report takes an in-depth look at the financial reporting world in 2004 by analyzing the leading causes and trends in financial restatements filed with the U. S. Securities and Exchange Commission for the five years ending December 31, 2004.

The report also provides observations regarding certain activities and events involving the various regulatory and standard-setting entities, the public accounting industry, and issues related to corporate governance.

We hope that you will find the *2004 Annual Review of Financial Reporting Matters* informative and useful. We welcome your comments and feedback, especially as to what additional analyses you might find helpful in future publications. Please do not hesitate to contact us to discuss the issues raised in the report.

Huron Consulting Group  
March 25, 2005

## Contents

<b>Introduction: Facts about the Database</b>	<b>3</b>
<b>Restatement Results: Overall Trends</b>	<b>4</b>
Restatements by Year Filed	
Major Accounting Issues	
Repeat Filers	
Restatements of Annual Audited Financial Statements	
Trends in Restated Annual Audited Financial Statements	
Growth in Restating Multiple Years	
Restatements by Company Size	
<b>Major Events Affecting the Financial Reporting World in 2004</b>	<b>8</b>
SEC	
PCAOB	
FASB, IASB and AICPA	
Public Accounting Industry	
Corporate Governance	
<b>Industry Analysis</b>	<b>17</b>
Manufacturing Industry	
Finance, Insurance, and Real Estate Industry	
Transportation, Communications, Electric, Gas, and Sanitary Services Industry	
Software Industry	
<b>About Huron Consulting Group</b>	<b>22</b>
Contact information	

# Introduction: Facts about the Database

Huron's report analyzes the leading causes of and trends in financial restatements filed in amended filings with the U.S. Securities and Exchange Commission (SEC) for the year ending December 31, 2004. The restatements tracked by Huron from 2000 to 2004 have been filed in both amended quarterly (10-Q/A) and annual (10-K/A) financial statements with the SEC.

The purpose of the analysis was two fold: First, to gather data on the size and industry of the registrants issuing restatements, and second, to review the underlying accounting error(s) that necessitated these restatements. The report also summarizes information about the type of financial statement (annual or quarterly) involved in the restatement.

## **As part of its analysis, Huron:**

- Performed a search of all 10-K/A and 10-Q/A filings in the SEC's EDGAR database from 2000 through 2004 using the keywords "restate," "restated," "restatement," "revise," and "revised."
- Conducted refined searches to include only "restatements" defined in APB Opinion No. 20 as a restatement of financial statements that resulted in an error. The report excludes any restatements filed as a result of changes in accounting principles, as well as any non-financial related restatements.
- Created a database comprised of all relevant information for each restatement identified, including the following fields: Company Name, SIC Code, Annual Revenues (from the most recent filing), Footnote Disclosure Describing the Restatement Issue, Classification of Restatement Issue, Restating 10-K or 10-Q, and Auditor of Record (limited to amended annual financial statements).

## **In addition, the following definitions and practices were used as part of the analysis:**

- Multiple amended filings by a single company for the same underlying purpose were counted as a single restatement. If the period being restated included an annual period, the restatement was recorded as a 10-K restatement. If only quarterly periods were being restated, it was recorded as a 10-Q restatement.

- The restatement data used in this report only includes amended financial statements that were recorded, not necessarily announced, by December 31, 2004. In addition, the report does not include any data on anticipated restatements; although beginning in August 2004, any company anticipating a restatement is required by the SEC to file an 8-K and issue a news release. Huron will begin tracking these 8-K filings beginning in 2005. Lastly, information from companies that announced a restatement, but then ultimately did not file amended financial statements with the SEC (e.g., filed for bankruptcy or were delisted), is not included in our restatement database.
- Huron's data collection process includes only information contained in the public filings and did not involve interaction with any of the companies listed in its database. As such, our interpretation of the accounting changes has not been verified by these companies.

# Restatement Results: Overall Trends

## Restatements by Year Filed

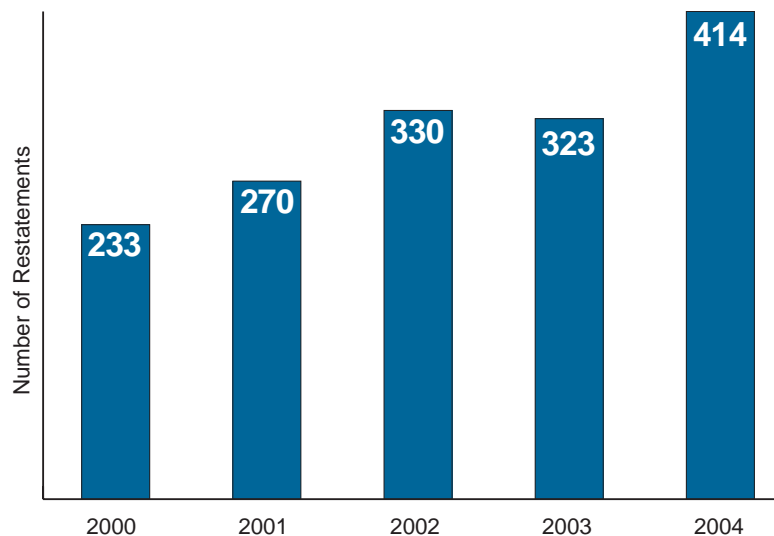
Huron's report covers financial restatements filed in amended filings with the U.S. Securities and Exchange Commission (SEC) for the year ending December 31, 2004 and includes both amended quarterly (10-Q/A) and annual (10-K/A) financial statements.

Amended filings of the financial restatements of public companies due to accounting errors totaled 414 in 2004; a dramatic 28 percent increase over the 323 restatement filings identified in 2003. The year 2003 was significant because it was the first time in four years that restatement filings had leveled off after trending upward since 2000 (2002 had 330 restatements, 2001 had 270, and 2000 had 233).

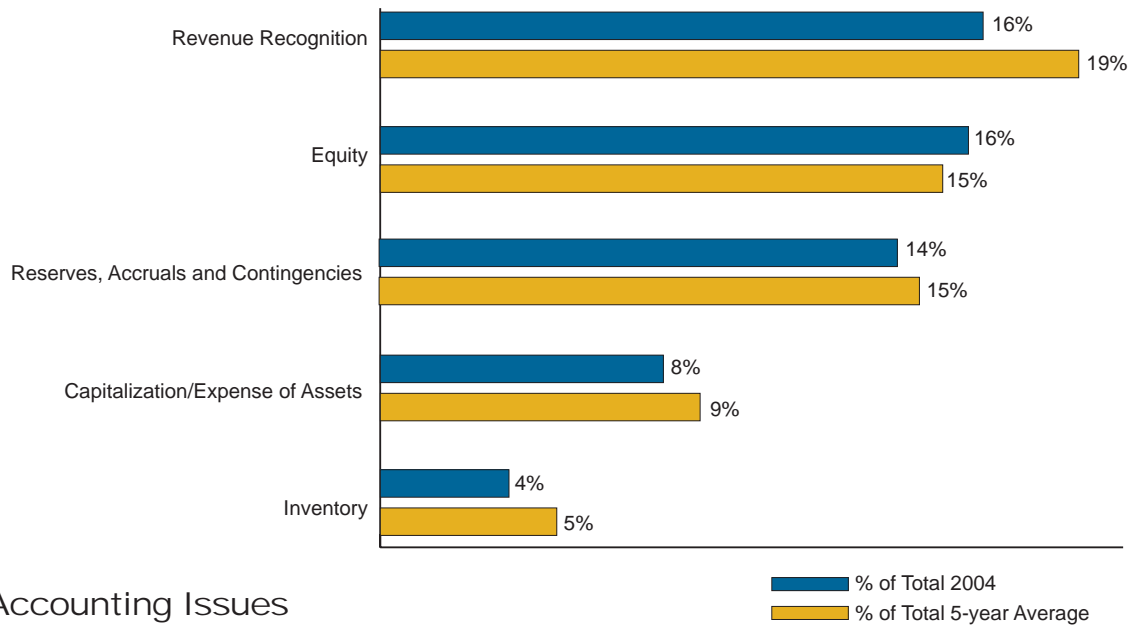
There were several trends and events affecting financial reporting in 2004. Among the most notable were those set in motion by the Sarbanes-Oxley legislation (SOX), including the creation and activities of the Public Company Accounting Oversight Board (PCAOB or "the Board"), implementation of Section 404 internal control procedures, and increased staffing and scrutiny by the SEC. In addition, the audit profession played a significant role during a "cleansing" year that appears to have been addressing many of the prior period errors that were corrected in 2004.

Without question, the new Section 404 requirements mandating that public registrants thoroughly document, test and take responsibility for the effectiveness of their company's financial reporting safeguards triggered this unprecedented level of scrutiny of the reporting process.

Restatements by Year Filed



## Major Accounting Issues



## Major Accounting Issues

Similar to previous years, five categories of accounting issues accounted for nearly 60 percent of the problems reported in the 2004 financial restatements. The underlying causes for these restatements included misapplications of accounting rules, human error, and ethical lapses.

The three most prevalent accounting issues were:

- Revenue recognition;
- Equity accounting; and
- Reserves, accruals and contingencies.

Accounting Issue	Explanation
<b>Revenue Recognition</b>	This category includes instances where a company has improperly recognized revenue on transactions.
<b>Equity</b>	This category includes errors involving stock option accounting, EPS accounting, and accounting for warrants and other equity instruments.
<b>Reserves, Accruals and Contingencies</b>	This category includes errors involved in accounts receivable and inventory reserves, restructuring reserves, accruals, and other loss contingencies.
<b>Capitalization / Expense of Assets</b>	This category includes instances where a company has improperly capitalized an expenditure that should have been expensed under GAAP (or vice versa).
<b>Inventory</b>	This category includes inventory valuation issues, inventory quantity issues, as well as cost of sales adjustments.

## Repeat Filers

Huron's analysis also revealed that 63 financial restatements, or 15 percent of those filed, had been filed in 2004 by "repeat filers" or registrants. These companies had encountered financial trouble in the past and reported erroneous financial information on more than one occasion since 1997.

Although a large number of companies reported accounting problems over the five years covered in this report, it is notable that many of the errors were reported by repeat filers. Fewer companies are contributing to the problem than the number of filings would indicate.

## Restatements of Annual Audited Financial Statements

While investors rely on both the quarterly and annual financial statements issued by public companies, auditors assume different levels of responsibility and follow different procedures depending on the type of statement being reviewed. For example, because auditors are required to render an audit opinion on annual financials, these statements are subject to a higher level of review than quarterly financials, which do not require an audit opinion.

In 2004, the number of filings involving restated annual audited financial statements rose to a record high of 253, representing 61 percent of the total restatements filed during the year. This compares to 64 percent in 2003, 55 percent in 2002, 52 percent in 2001 and 42 percent in 2000.

### Trends in Restated Annual Audited Financial Statements

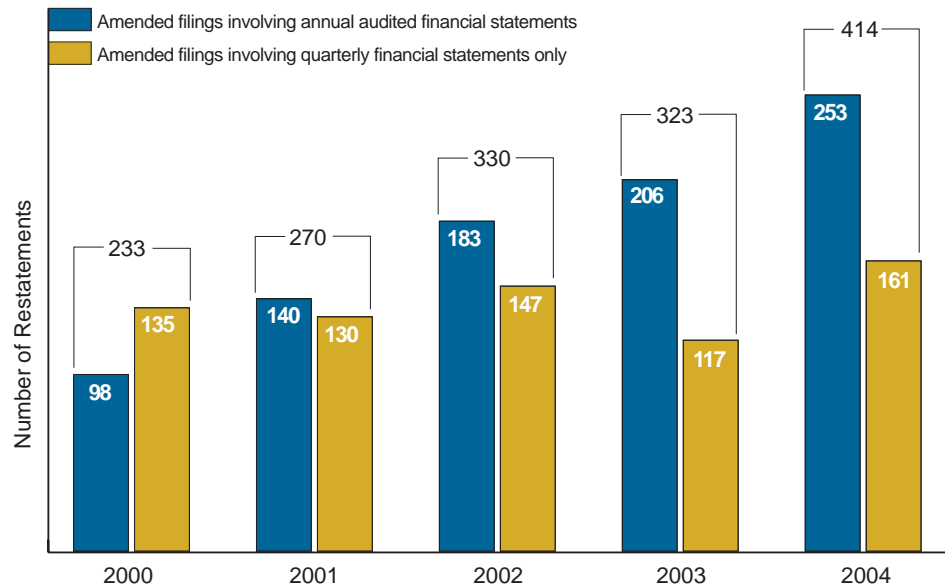
As described earlier, the number of amended filings involving annual audited financial statements rose in 2004 to 253. Huron also tallied the gross number of restated annual financial statements included in these filings and observed a similar trend with 508 restated audited annual periods being included in the 253 filings.

### Growth in Restating Multiple Years

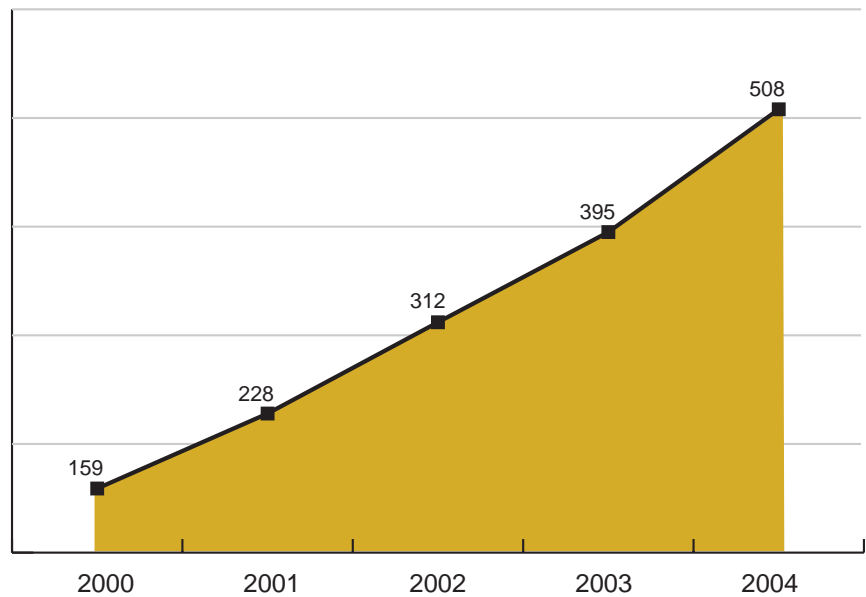
Huron's report also uncovered a rising trend in the number of periods contained in each restatement. For the fifth consecutive year, the number of filers reporting errors in at least three of the prior annual periods rose to nearly 40 percent of the 10-K/A filings.

Multiple period restatements point to recurring flaws in accounting policies, practices, and errors, as opposed to one-time errors.

## Restatements Involving Annual Audited Financial Statements



## Trends in Restated Annual Audited Financial Statements



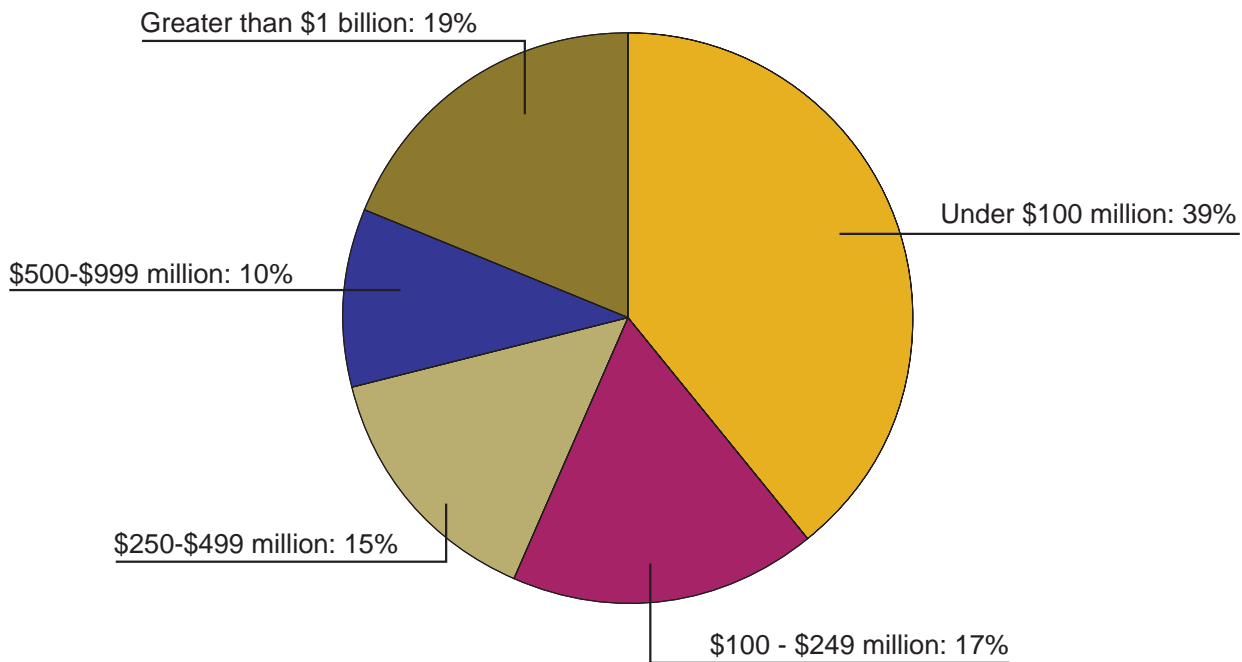
## Restatements by Company Size

Restatements by companies with less than \$100 million of revenue accounted for 39 percent of restatements in 2004, down from 49 percent in 2003.

In 2004, companies with more than \$1 billion in revenue accounted for 19 percent of restatements, down slightly from 20 percent in 2003.

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.

### Company Size (2004)



# Major Events Affecting the Financial Reporting World in 2004

## SEC

**Don't gloat the next time your competitor is in the news with a problem. Instead, get ready for a knock at the door.**

In July 2004, the SEC explained that the Office of Risk Assessment (ORA) was created to "improve the agency's ability to anticipate potential problem areas across the securities industry, and...focus on early identification of new or resurgent forms of fraud and illegal or questionable activities."

Through the remainder of 2004, the ORA "explored" pension accounting matters, which resulted in subpoenas to major companies inquiring about the assumptions upon which they determined pension liabilities. It appears that the ORA will allow the SEC to take a more proactive approach and assist in the early identification of possible problems.

Directed from either the ORA or a state's Attorney General's office, a process known as industry or issue "sweeps" is triggered to target groups of companies based on the identification of a problem with one registrant to see if it is occurring among other companies in the same industry or facing similar issues.

Recent sweeps have ranged from reviews of mutual fund practices, to an inspection of oil and gas industry estimates, to scrutiny of the conduct among companies within the insurance industry.

What industry practice is next? What accounting treatment will soon be called into question? Clearly this is a trend

worth tracking, and even predicting, considering that today's headlines may provide signs of the next "isolated problem" worthy of review.

**What happened to all the noise about "noisy withdrawals"?**

One of the many corporate governance improvements sought by the Sarbanes-Oxley Act legislation was to increase the responsibility of legal professionals to report any legal wrongdoing uncovered or witnessed in the course of their work. As a result, new "up the ladder" reporting rules were proposed under Section 307. Under the proposed rules, attorneys would first be required to report any evidence of a material violation to a company's chief legal counsel or chief executive officer (CEO).

Then, if the reporting attorney felt an appropriate response had not been provided in a reasonable amount of time, the attorney must then report the material violation to either an independent committee of the board of directors or to the full board. Next, in the absence of an appropriate response from the board, the attorneys would be required to withdraw their representation from the offending company, notify the SEC of the withdrawal and disaffirm any tainted documents.

Known as the "noisy withdrawal" proposal, the proposed rules drew serious objections from the American Bar Association. The objections, summarized in a 2004 policy position paper, cited among other things, conflict with current state court rules regarding attorney-client privilege.

As a result, in April 2004 the Commission announced that it has not yet decided to proceed with a mandatory "noisy withdrawal" rule and, as of year-end, no decision has been rendered as to whether these rules will ever take effect.

**Introducing the corporate "probation officer" – The role of the special monitor.**

In 2004, several settlements with regulatory and enforcement authorities involving the appointment of a "special monitor" were observed. This new role (which may be viewed as the corporate version of the probation officer) is an interesting development. However, it is too early to determine whether the use of

special monitors is a temporary fad or will become a regular practice across corporate America. If the use of special monitors does become a regular practice, what are the implications to the company, to the regulatory agencies, and especially to the auditor?

From the government's perspective, although the cost of the special monitor will generally be borne by the company (i.e., the shareholders), the monitor itself will report externally to the government agency or agencies involved in the settlement. It is easy to understand the government's motivation.

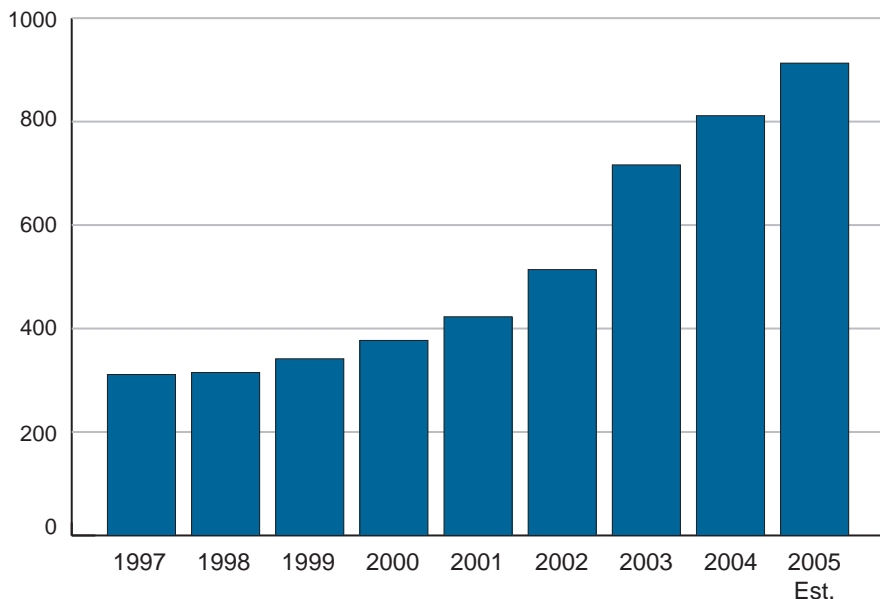
**"We need to reach beyond investigating the cause of every announced restatement, to probe industries or practices about which we have concerns or suspicions, but no clear roadmap to wrongdoing."**

Stephen M. Cutler, Director, Division of Enforcement, SEC  
Remarks Before the District of Columbia Bar Association,  
February 11, 2004

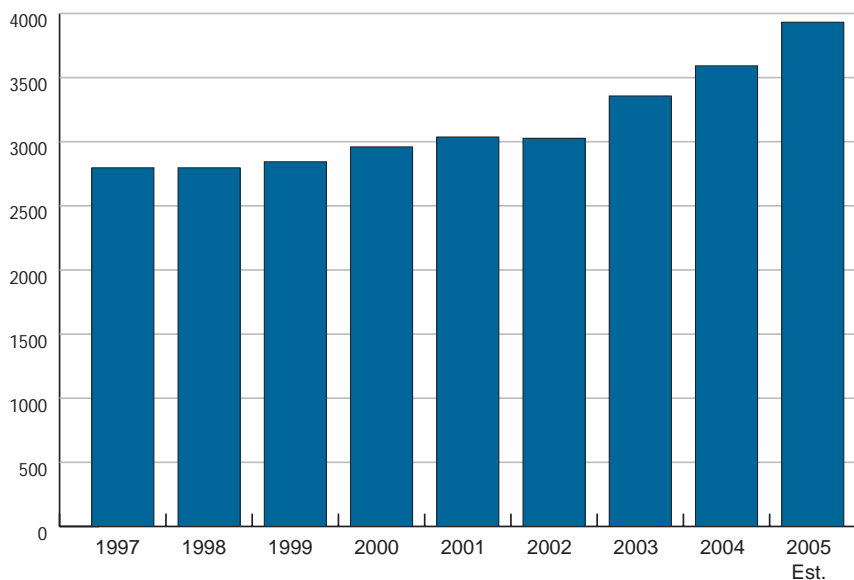
**"... we have hired more than one thousand professional employees – accountants, lawyers, economists – since December 2002, and we have another 100 set to come aboard in the coming months. This represents a 27 percent increase in the SEC's professional staff, from roughly 3,000 to nearly 4,000."**

William Donaldson,  
Chairman, SEC  
Remarks from the Conference Board's 2004 Annual Dinner,  
October 14, 2004

**Figure 1: Budget Authority FY 1997 - 2005 (to nearest million)**



**Figure 2: Authorized Full Time Equivalents (FTEs) FY 1997 - 2005**



For the reporting company, the monitor is like having an ongoing examiner, which certainly gives new meaning to the word "transparency." Depending on the scope of the monitor's work, incremental company resources (in both time and money) may be required. Clearly some companies may object to this additional financial burden. However, for many the need to quickly move beyond the problems of the past may outweigh the negatives. Many companies may be willing to accept the monitor as part of a

settlement, especially when it can be used to mitigate other aspects of punishment. It also sends a strong public message that the company has nothing to hide, which can be very valuable in restoring investor confidence.

This will be an interesting development to follow, and may provide new opportunities for retired government officials, judges and other respected members of the business community to serve the public interest.

**The SEC's 2004 - 2009 Strategic Plan: Goals, Priorities, and Initiatives.**

Established by the Securities Exchange Act of 1934, the SEC is an "independent, quasi-judicial agency that operates under a bipartisan Commission appointed by the President and confirmed by the Senate, and headed by a Chairman."

Its mission is "to protect investors; maintain fair, orderly, and efficient markets; and facilitate capital formation." Clearly, the Commission bears a tremendous responsibility, as it works to monitor and protect both our capital markets and our overall economy.

In recognition of the critical role it plays in our country's economic health, the SEC has received significant funding increases over the past several years, more than doubling its budget since 2002. However, at the time this report went to press, it appears that this trend may be coming to an end.

President Bush's proposed federal budget calls for a 2.7 percent reduction in the SEC's budget for FY2006. This raises questions about the Commission's ability to execute its five-year strategic plan, which was released in 2004.

The strategic plan details the Commission's goals, priorities and initiatives. Figures 1 and 2 are taken from the Strategic Plan and illustrate the Commission's growth over the last several years.

The facts and figures are not the most important items in the plan. The most critical items are the key strategies to be deployed across all programs, including:

- Leveraging resources with other federal, state, and foreign governments, as well as domestic and international organizations, to maximize the effectiveness of regulatory, enforcement, and educational activities;
- Expanding risk-based assessment practices to better anticipate emerging risks and market trends that may threaten the Commission's ability to fulfill its mission or potentially harm

- investors and market participants;
- Applying technology to enhance the operational effectiveness of the agency and to improve public access to SEC filings and other information; and
- Sustaining and improving organizational excellence.

The SEC's five-year strategic plan is available at: <http://www.sec.gov/about/secstratplan0409.pdf>

**Are all "penalties" created equal? According to the victims, not always.**

Under Section 308 of SOX, the Commission can place the proceeds from certain civil penalties, which previously went into the U.S. Department of the Treasury, into a "Fair Fund" for distribution to the investors that suffered losses. This is one of the most laudatory aspects of the SOX legislation.

However, individual states do not always follow a similar plan to help victims of financial fraud and wrongdoing. Because of balanced budget pressure, some states use enforcement actions as a way to generate needed revenue and fill their coffers.

The Putnam Investments settlement agreement offers a perfect example of discrepancies between state and federal decisions as to how benefits should be distributed. Per Putnam's April 2004 press release, "Under the terms of the SEC agreement, Putnam will pay \$5 million in disgorgement and a \$50 million penalty, all of which will be distributed to shareholders in the funds. According to the agreement with the Office of the Secretary of the Commonwealth of Massachusetts, Putnam will pay \$5 million in restitution to shareholders in the funds and a \$50 million penalty to the Commonwealth of Massachusetts."

Here we have one problem, with two actions, and for the victims, two very different results. Which result would most investors desire?

# PCAOB

**Auditor inspections made public. Read all about it!**

SOX requires the PCAOB to conduct annual inspections of the major audit firms. In August 2004, the industry had its first look at what to expect from this process, as the Board issued its report on the limited scope inspections (conducted in 2003) of the "Final Four" accounting firms.

The inspections evaluate compliance with generally accepted auditing standards and quality control functions of the firm. In performing the inspections, the Board considers the firm's policies, practices and procedures for auditing public registrants and selects recently performed audits for evaluation.

In the old days, this evaluation occurred through a peer review process, whereby the major accounting firms looked at each other's work as an inside-the-profession self-policing mechanism. The role of the Board as the "new sheriff in town" certainly has made this assessment more transparent, and is clearly a step in moving auditing closer to becoming a regulated profession.

None of the firms earned a perfect score in this first year of inspections, and the reports did identify "significant audit and accounting issues that were missed" by the former peer review system. The review also identified "concerns about significant aspects of each firm's quality control systems." However, on a more positive note, the Board expressed confidence in the profession as a whole, praising the firms for both their cooperation and high quality auditing capabilities.

A benefit of this process will be the Board's ability to apply what it has learned during these inspections to its auditing standards rule-making process, which is currently happening.

**The evolution of "Generally Accepted Auditing Standards": New rules – and more to follow – Audit documentation tops 2004 bestseller list.**

In 2004, the PCAOB issued guidance for auditors who report on internal controls, outlined requirements for audit files and documentation, and clarified where the independence line will be drawn for tax services. Perhaps even more significant is what will be on the horizon for rule-making and the proposed "redefinition" of auditor responsibilities and expectations.

Some of the most notable areas currently under evaluation include:

- Guidance for performing risk assessments to determine proper audit tests;
- Detection of, and reporting on, financial fraud;
- Auditing-related party transactions;
- Use of confirmations in an audit;
- Auditing fair value measurements and disclosures;
- Auditor quality control systems and requirements; and
- Communications with audit committees.

One of the key concerns for the PCAOB will be closing the gap between the level of assurance investors believe audits provide, and the level of assurance actually provided. Auditing standards require auditors to plan and perform an audit that allows the auditor to express reasonable assurance that the financial statements are free from material misstatement. However, the same auditing standards also note, in SAS 99, "Consideration of Fraud in a Financial Statement Audit," that:

"...even a properly planned and performed audit may not detect a material misstatement resulting from fraud. A material misstatement may not be detected because of the nature of audit evidence or because the characteristics of fraud as discussed above may cause the auditor to rely unknowingly on audit evidence that appears to be valid, but is, in fact, false and fraudulent."

***"None of our findings has shaken our belief that these firms are capable of the highest quality auditing."***  
 William McDonough,  
 Chairman, PCAOB  
 U.S. Audit Firms Used Wrong  
 Standards, Report Says  
*Bloomberg, August 26, 2004*

Clearly, an audit performed under existing auditing standards does not provide (and does not intend to provide) absolute assurance that the financial statements are free from material fraud. Yet, based on the outcries of "where were the auditors?" each time a financial reporting fraud is announced, investors seem to believe otherwise.

The PCAOB has set an ambitious agenda with regard to its responsibilities for setting auditing standards. Ensuring that investors understand exactly what level of assurance those standards do and do not provide is as important as the effectiveness of the standards themselves.

**The new and improved reportable conditions: control deficiencies, significant deficiencies, and material weaknesses.**

As a result of the 2004 issuance of the PCAOB's Auditing Standard No. 2, the industry now has new definitions under which shortcomings in a public company's accounting systems and control processes can be categorized.

While clear in theory, the practical application of these definitions will be subject to interpretation depending upon the situation in which they are applied. This in turn will likely cause debate. For example, consider how the following definitions might be interpreted:

- Control Deficiency: "...exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis."
- Significant Deficiency: "...a control deficiency, or combination of control deficiencies, that adversely affects the company's ability to initiate, authorize, record, process, or report external

financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the company's annual or interim financial statements that is more than inconsequential will not be prevented or detected."

- Material Weakness: "...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."

The most intense debate will likely occur over determining what constitutes a

***"The preliminary reactions that I have heard to date vary somewhat, but they do seem to be generally consistent in that not all material weaknesses are likely to be viewed as equally significant. Said another way, some material weaknesses may have a greater or lesser impact on an investor's decision making process. In many cases this decision will likely be influenced by the fullness of management's disclosure, the underlying causes of the material weakness, and management's actions to address the material weakness. This is intended to be an open process whereby investors can evaluate both the weakness as well as management's actions to improve controls."***

Donald T. Nicolaisen,  
Chief Accountant, SEC

Keynote Speech , 11th Annual Midwestern  
Financial Reporting Symposium, October 7, 2004

material weakness, and what meets the lesser charge of a significant deficiency, as only material weaknesses must be publicly disclosed.

While the reporting of a material weakness by a registrant will give investors cause for concern, equally important will be the cure that follows, and the resulting control improvements that will be put in place to ensure the problem does not happen again.

**Lowering growth expectations isn't just for registrants anymore!**

***"We would like more [experienced auditors on the team], but we recognize that this is a very tight employment market."***  
Thomas Hohman, CFO, PCAOB  
Hiring troubles hit PCAOB hard, *Accounting Today*,  
January 24, 2005

At year-end, the PCAOB released a surprise announcement stating that it would cut its 2005 budget. According to a December 2004 press release, the Board had reassessed its hiring plans in light of fierce competition for auditors and accountants, and realized its 2005 goals were too high.

The original plan called for the PCAOB to have 300 people by year-end 2004, and to increase its headcount by 50 percent during 2005. However, the PCAOB finished the year with approximately 260 people, and downgraded expectations accordingly for 2005.

In light of these changes and the tight labor market for skilled accounting and auditing professionals, the Board announced that it "may need to re-evaluate compensation in order to retain, and continue to attract" needed talent. The impact of the Board's inability to meet its personnel goals in light of its ambitious inspection schedule remains to be seen and should be followed closely.

# FASB, IASB and AICPA

## The many meanings of "value."

It may look like science with its scores of complicated calculations, but performing a valuation is as much art as it is science. Not surprisingly, the results can differ dramatically depending on how conservative or aggressive are the assumptions used in the valuation analysis. Add to this the inherent judgment involved in valuing items such as intangibles and other long-lived assets, and it makes one realize the importance of consistent standards for performing valuations.

In 2004, the SEC punished a major financial services firm for inappropriately modifying how the fair values of certain financial instruments were determined. Under the current FASB standard, fair value is "the amount at which an asset (or liability) could be bought (or incurred) or sold (or settled) in a current transaction between willing parties, that is, other than in a forced or liquidation sale." Because the market for the financial instruments held by the registrant was illiquid (i.e., a "buyer's market"), the registrant instructed the appraiser to determine fair value not based on what it could receive in a current transaction with a willing buyer, but on an assumption of what it could receive under "normal" market conditions. This method not only ignored market price information, it also denied the current market's relevance and took a longer time-horizon view for the assets' valuation. As a result, the appraisal reflected a valuation for more than the current market price of the asset.

While this case illustrates a situation in which a registrant made an error, it also highlights the need for consistent practice and guidance on appraisal matters. Each year, more and more valuation concepts are applied in financial statements. Yet the appraisal profession remains a diverse collection of designations and specialties. It is important that the

valuation concepts applied by registrants in their financial reports be consistent - both to avoid application error, and to ensure comparability among financial statements.

## Caution: accounting standards merging (or not).

During 2004, both the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) continued their efforts to agree on high-quality review standards. As part of its short-term project to converge with IASB standards, FASB issued amendments to ARB No. 43 and APB Opinion No. 29, and proposed amending FASB Statement No. 128.

Also during 2004, the FASB and the IASB undertook a new joint project to develop a common conceptual framework to be used as a basis for future accounting standards, and formed a joint working group to discuss issues arising in the long-running project on improving the usefulness of financial statements.

On the other side of the pond, the IASB issued standards on asset disposals and discontinued operations, as well as business combinations, goodwill, and intangible assets, that narrow the differences between the previous international standards and the comparable U.S. standards.

Finally, both Boards stood up against tremendous lobbying to adopt final standards on accounting for share-based payment arrangements. However, even these new standards include significant differences in certain areas that will require further effort before true convergence can be achieved. As an added bonus, the European Commission (EC) endorsed the IASB standard on February 7, 2005, requiring that all listed

European companies adopt the standard as of the beginning of 2005.

Is there a message to Congress in the EC's action, and are the FASB's opponents on Capitol Hill listening?

## Heard the one about "Big GAAP" vs. "Small GAAP"?

If the American Institute of Certified Public Accountants (AICPA) has its way, there will be a set of accounting standards for public companies, and another set for private companies. If this were to happen, companies would not have to apply Generally Accepted Accounting Principles (GAAP) under certain circumstances. Referred to as "Big" versus "Small" GAAP, this concept is also known as "differential" accounting.

Before dismissing this concept outright, it's important to remember that many countries already employ different levels of accounting rules for public and private companies. The real question that needs to be addressed is whether GAAP is too complex and costly for smaller entities to apply. And, could users of public and private company financial statements accurately and reliably compare their statements?

Underlying this topic are two key observations that help put the discussion into context.

First, the FASB is now funded by fees from public registrants and therefore some parties believe that it does not adequately represent for the interests of private entities. Second, and perhaps more significant, is the AICPA's recent focus on serving the needs of private companies, which has increased since it lost its role as audit standard-setter following the creation of the PCAOB.

***"If 50 percent of our economy is in the public companies, the writing of their standards has to be done and has to be done well. But that doesn't mean that those same standards have to apply to corner grocery stores. Differential standards are not a threat to FASB at all."***

Barry Melancon,  
President & CEO, AICPA  
*Differential Accounting:  
Problems & Possibilities,  
Financial Executives  
International, March/April 2004*

## Congratulations to the Class of 2004!

Various accounting rule-making entities or bodies issued new pronouncements this year:

- Statement of Financial Accounting Standards No. 123 (Revised 2004), *Share-Based Payment*
- Statement of Financial Accounting Standards No. 151, *Inventory Costs - An Amendment of ARB No. 43, Chapter 4*
- Statement of Financial Accounting Standards No. 152, *Accounting for Real Estate Time - Sharing Transactions - An Amendment of FASB Statements No. 66 and 67*
- Statement of Financial Accounting Standards No. 153, *Exchanges of Nonmonetary Assets - An Amendment of APB Opinion No. 29*
- International Accounting Standard (IAS) 19, *Employee Benefits (amendment)*
- IAS 36, *Impairment of Assets (amendment)*
- IAS 38, *Intangible Assets (amendment)*
- IAS 39, *Financial Instruments: Recognition and Measurement (amendment)*
- International Financial Report Standard (IFRS) 2, *Share-Based Payment*
- IFRS 3, *Business Combinations*
- IFRS 4, *Insurance Contracts*
- IFRS 5, *Non-Current Assets Held for Sale and Discontinued Operations*
- IFRS 6, *Exploration for and Evaluation of Mineral Resources*

**"I've expressed my view to the CEOs of the big firms that I think it is their responsibility not to run away from the marketplace. [The requirements in the 2002 law] should not be a convenient tool for them to manage their business. They do have a responsibility [to] the public trust."**

Donald T. Nicolaisen,  
Chief Accountant, SEC  
Big Four Seen Shedding  
Small Clients, CFO.com,  
September 21, 2004

## Public Accounting Industry

### Auditor resignations – not so fast!

Not long ago, audit firms were fighting for new clients. Today, at least with smaller public companies, firms are walking away from many of their existing clients.

Like never before, auditors are scrutinizing the risks and rewards of client relationships. The biggest reason for this phenomenon is very simple: the firms have a limited professional staff and an ever increasing workload. The result of this equation is that all clients are not created equal, and some just naturally receive priority over others. According to AuditAnalytics.com, Big Four firms resigned from 210 public

registrants in 2004, a 38 percent increase over the number of resignations reported in 2003.

This trend hasn't gone unnoticed by the SEC, and the Chief Accountant recently sent a 'reminder' to the profession about maintaining its "public" responsibility. Because privately held audit firms are granted a license to serve the investing public through the audit function, they do serve a unique and special role in our capital markets. But choosing which clients they want to serve remains a very private matter.

**The J.D. Power "seal of approval" doesn't just apply to what's in your driveway – it now applies to who's in your annual report.**

The marketing departments at Deloitte & Touche and Grant Thornton received an early holiday gift when J. D. Power and Associates issued its 2004 Audit Firm Performance Study in November. Deloitte won the top honor for client satisfaction with more than \$1 billion in

revenues, while Grant Thornton took home the trophy for customer service to clients with revenues less than \$1 billion.

The survey was based on interviews of more than 1,000 audit committee chairs and almost 1,000 CFOs. Interestingly, the highest rated firms were those that emphasized communication. This may be the primary factor for auditors interested in improving their competitive position. The report found a direct correlation between holding candid discussions and asking "tough questions" about a client's operations and higher satisfaction scores. It turns out this is exactly what the investing public wants as well!

However, it's important to remember that although winning the J.D. Powers customer service award is quite an honor, auditing itself is first and foremost a service relied upon by the investing public and is not intended to be a popularity contest among competing firms. That said, winning these types of awards certainly offers more marketing pizzazz than sharing inspection reports from the PCAOB. So don't be surprised if the J.D. Power "seal of approval" is what makes it into next year's glossy marketing brochures.

### For your next Trivial Pursuit game: the history of the audit.

Did you ever wonder who completed the first audit? History is filled with numerous references to testing (or auditing) the representation of people's statements. According to "Managing the Audit Function: A Corporate Audit Department Procedures Guide," ancient Egyptian writings dating back 2,500 years make reference to "audits," and early Greek and Roman literature also refer to "audit" and "auditing accounts."

The earliest form of the audit as we know it today (that is, a review of financial practices performed by independent public accountants) occurred in the early 1700s in England following a major scandal known as the South Sea Bubble. This event highlighted the value of the audit and helped shape the profession as we know it today.

In 1896, the U.S. auditing profession was legitimized when the State of New York issued the first Certified Public Accountant (CPA) certificates to individuals passing a qualifying exam. Shortly thereafter, all states passed CPA license requirements and laws.

Just as the South Sea Bubble scandal nearly 300 years ago helped shape the audit profession of today, the major corporate scandals of the last few years are shaping the profession of tomorrow.

### Many registrants feeling the consequences of auditor "independence."

The message to auditors following the passage of the SOX legislation was clear: remain truly independent of your audit clients and be forever mindful to serve the investing public. Since 2002, the SEC and the PCAOB have continued to address the issues surrounding auditor independence. And while none of the issues raised were really new, many welcomed the legislation because they felt the profession needed a reminder of its obligations. It appears today that although independence issues may still arise on occasion, the desired objective of reinforcing auditor independence seems to have been accomplished.

However, the impact of the SOX legislation, particularly as it relates to the required reporting on internal controls over financial reporting, has definitively changed the relationship between registrants and their auditors, resulting in several consistent gripes from many CFOs and accounting staff. Here is what some of the discussions sounded like in 2004:

- "My auditor won't even answer my questions about an accounting question until I write a memo and have an answer myself - and then, if I get the wrong answer on a significant issue, I have a material weakness in internal controls over financial reporting."

- "There is tension in the discussions about accounting judgments with my auditor, and not a lot of flexibility."
- "My auditor might as well be a regulator; we just don't have the same relationship anymore."
- "I need a new advisor on many of the things that I used my audit firm for in the past."

In addition, there are some who feel that auditors have taken the independence issue to an extreme by declining to assist their clients on difficult accounting issues. The next step in this evolution will be for registrants to adjust and fill the void created by this shift. This can be accomplished by adding resources internally or by hiring new service providers as consultants. There is no question that the rules have changed and it's a new game out there. Many companies are just now realizing how much they used to depend on their auditor and that the burden is on them to adjust to a new reality.

***"As we approach the third anniversary of the implosion of Enron, the single greatest impediment to the restoration of confidence in corporate America is continuing instances of extravagant non-performance based compensation."***

Arthur Levitt Jr.,  
former Chairman, SEC  
Money Money Money,  
*The Wall Street Journal*,  
November 22, 2004

## Corporate Governance

### So how much is your CEO really worth to the shareholders?

While scrutiny and new rules have brought changes to the world of corporate governance, some feel that executive compensation is excessive and is not being addressed in a timely or effective

manner. This issue has been front and center in several public discussions including the recent stock option accounting debate, during Disney's highly publicized trial over fair compensation, and as a result of the executive compensation disclosures in public filings.

Today's mantra for executive compensation seems to be "transparency and accountability are best." Fairness and linking equi-

ty incentives to performance-based measures are currently in vogue as the most popular compensation committee objectives.

However, despite significant regulatory and legislative change, there are many who feel more needs to be done to address the issue. So whose job is it to drive further change in this arena? There seems to be little more that can be done by regulators or legislators, which places this issue squarely where it belongs: on the shoulders of corporate shareholders. Initiatives to watch include the California Public Employees' Retirement System's (CalPERS) campaign to monitor and report on executive compensation, as well as the recent proposal by former SEC chairman Arthur Levitt Jr., in *The Wall Street Journal* calling for the creation of a committee funded by institutional investors that would analyze and report on "best practices" for compensation committees.

## Defining the "F" in CFO – is it for "finance" or "financial"?

The role of the chief financial officer has evolved in corporate America. Surveys indicate that today's CFOs spend more time on "deals" and "strategy" than on financial reporting. While having a finance wiz and visionary may be what the CEO and board desires, it may not be aligned with the investing public's expectations of today's chief "financial" officer. Investors look to the CFO as the individual with primary responsibility for the company's financial reporting in accordance with GAAP, which many would argue is a full-time endeavor.

Some companies have already addressed elements of this "expectation gap" by elevating the most senior accounting professional to a "C" level position, through the creation of the Chief Accounting Officer position. While such a move doesn't ensure that a registrant will be free from accounting problems, it does display the appropriate level of importance that financial reporting requires in the executive suite. Further clarity in these responsibilities will benefit senior finance and accounting executives in meeting their job responsibilities.

### It's not just about systems – getting the people part right counts, too.

Automation and systems may have removed much of the labor component from the manufacturing sector, but financial reporting still requires human judgment and analyses in which there is no substitute for competent accounting and financial reporting experts.

Attracting and retaining the right people is one of the most critical aspects of quality financial reporting and is a challenge that new rules, regulations, or technologies can't solve. Having a

sufficient number of people with the right experience and expertise in the accounting and finance department is something that will be scrutinized by registrants during their internal control tests and reports under SOX 404.

According to a January 11, 2005 article by Compliance Week, 582 companies disclosed material weaknesses or significant deficiencies in their internal controls in 2004. Financial systems and procedures (50.1% on average) were cited as the primary weakness, followed by personnel issues (29.6% on average).

Companies can no longer afford to view the accounting department as a cost center to be contained. An accounting department staffed with personnel who have well-developed technical skills should be viewed as part of a company's risk management program. After all, it is less expensive to pay to attract the right talent today than it is to defend against the inevitable torrent of lawsuits and investigations that commence if significant accounting deficiencies surface.

### Board changes and activities: Take a look inside.

Thanks to an analysis entitled, "Corporate Governance Practices of the 100 Largest U.S. Public Companies" by the law firm Shearman & Sterling LLP, we are able to review the changes and

activities of the boards of directors for the largest 100 companies in the United States, as reported during the 2004 proxy season.

The Shearman & Sterling LLP report includes the following highlights:

#### *Independent Directors*

NYSE & NASDAQ require that boards have at least a majority of independent directors, but 46 of the top 100 companies have adopted even more stringent standards. Independent directors comprise at least 75 percent of the board at 81 of the top 100 companies. At 35 of the top 100 companies, the CEO is the only non-independent director.

#### *Financial Experts*

SEC rules require companies to disclose whether they have a financial expert on their audit committee, and if so, who it is. Per the analysis, 42 of the top 100

companies indicated that they had more than one financial expert on their audit committee, and of these 42, 17 disclosed that their entire audit committee was comprised of financial experts.

#### *Meetings*

According to the report, full boards met only slightly more in 2003 than in 2002. However, committee meetings did become more frequent during this period. There was a notable increase in the number of companies reporting more frequent audit, governance/nominating and compensation committee meetings.

#### *Multiple Boards*

According to the report, 29 of the top 100 companies placed limits on the number of boards on which their directors could serve. However, most of those 29 approved exemptions for board members as of the enactment dates. Interestingly, 47 of the top 100 companies have

***"This is the reason there is SOX 404. These reports are akin to termites coming out of the woodworks – you would have never known they were there...Interesting SOX did not mandate a single addition[al] control and yet now we are learning of ones that did not exist."***

Lynn E. Turner,  
former Chief Accountant, SEC

***"I suspect that the costs [of implementing Section 404] are not easy to estimate, but I know that it is even tougher to quantify the benefits. However, given the massive financial scandals, decline in market capitalization and resulting loss of investor confidence in our markets, I believe that, of all of the recent reforms, the internal control requirements have the greatest potential to improve the reliability of financial reporting."***

Donald T. Nicolaisen,  
Chief Accountant, SEC  
Keynote Speech at 11th Annual  
Midwestern Financial Reporting  
Symposium, October 7, 2004

imposed limits, through their audit committee charters, on the number of other audit committees on which their members may serve.

The report also addresses director compensation packages and other structural and governance related matters. It's a very useful and informative analysis, and a "must read" for those wanting to observe shifts and trends in the corporate governance world.

#### **2004: The Year of the Internal Auditor – Courtesy of SOX 404.**

Even with all of the high profile financial reporting events and news in 2004, it would be hard to top the amount of

discussion and activity surrounding the documentation and testing of registrants' accounting control processes. Major questions that arose during these discussions include:

- If the controls have always been in place, why has the implementation process been so hard for some registrants to accomplish?
- What will the market and regulatory punishment be for material weakness reports?
- Should "small" public registrants really have to incur the expense of this process?
- Does an auditor determination of company control problems today call into question prior auditor reliance on

those systems?

- Can it be considered a material weakness if a registrant's accounting and finance staff relies on their auditor for guidance and interpretations of GAAP?
- Have reporting risks been minimized by this work?
- Do the benefits to investors and the public markets outweigh the significant costs and distractions caused by this work?

Clearly, there wouldn't be so much discussion if these questions had easy answers. However, one thing is certain: as a result of the implementation of SOX 404, the internal auditor has never felt so important!



# Industry Analysis

Consistent with prior years, Huron has tracked restatement issues by industry. The industry breakdown is based on the U.S. Government Standard Industrial Classification (SIC) codes that a registrant must indicate on its financial restatement.



Over the past five years, the following four industries have experienced the greatest number of restatements:

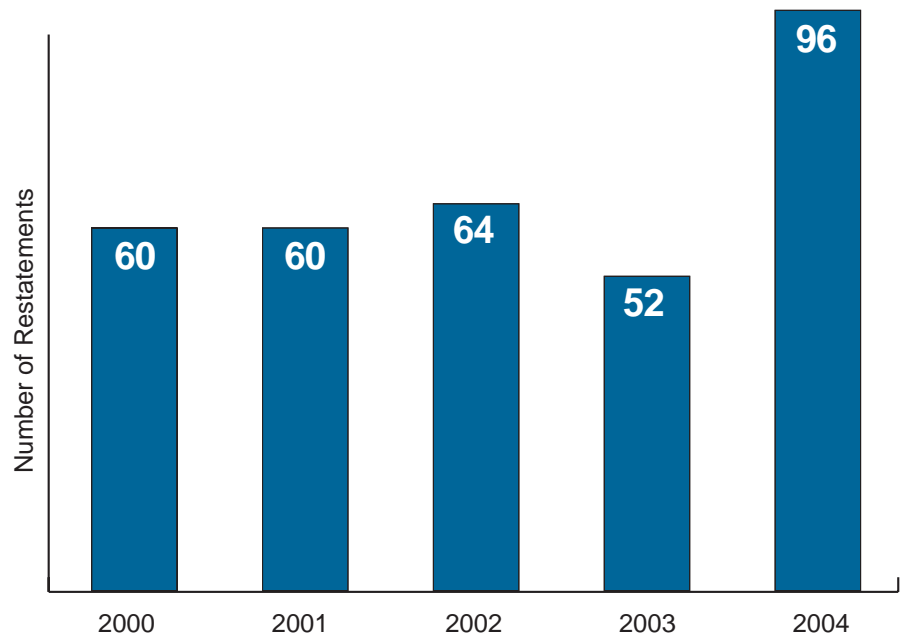
- Manufacturing;
- Finance, Insurance, and Real Estate;
- Transportation, Communications, Electric, Gas, and Sanitary Services; and
- Software.



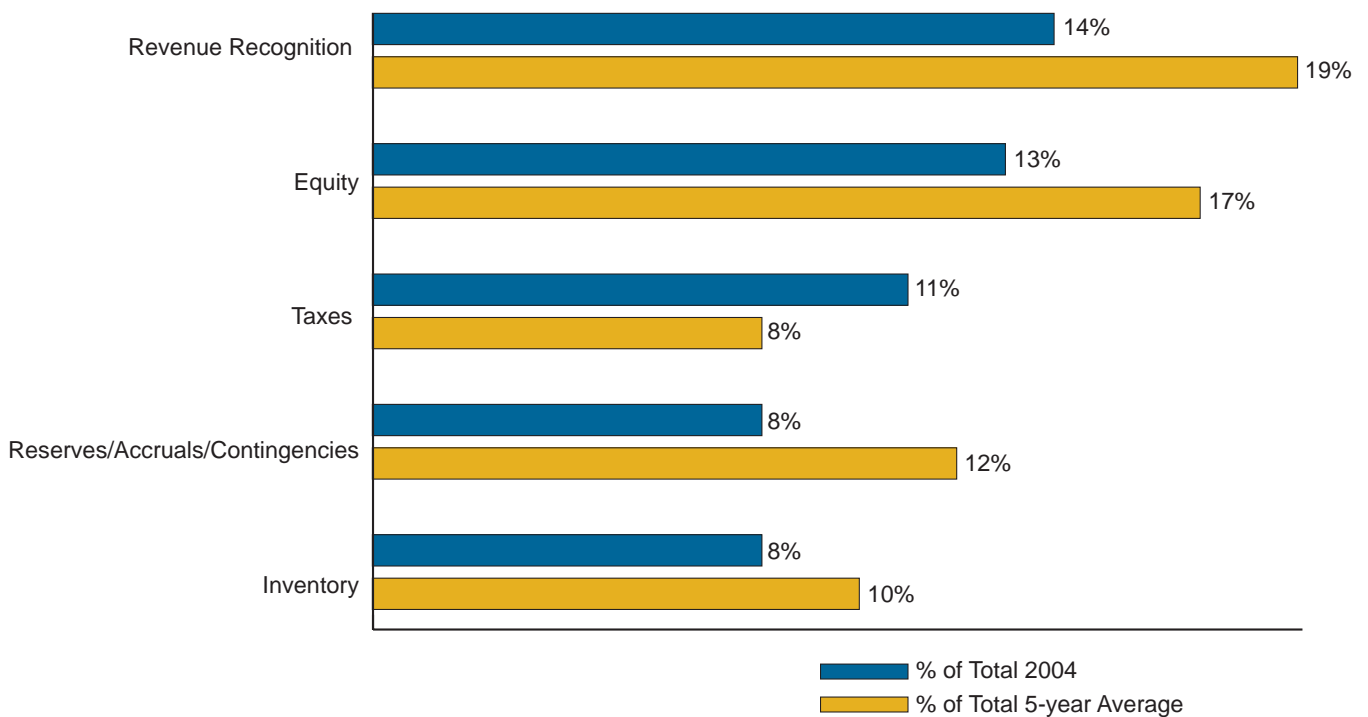
The following charts illustrate the breakdown of accounting issues underlying restatements in 2004, as well as the number of restatements in each industry over the past five years.

# Manufacturing Industry

### Restatements by Year Filed

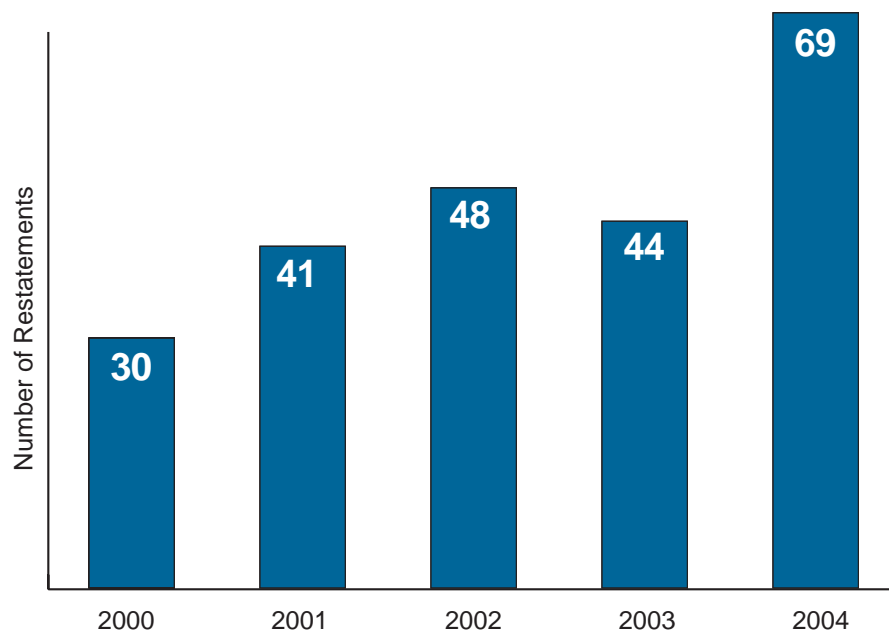


### Top Five Accounting Issues (2000-2004)

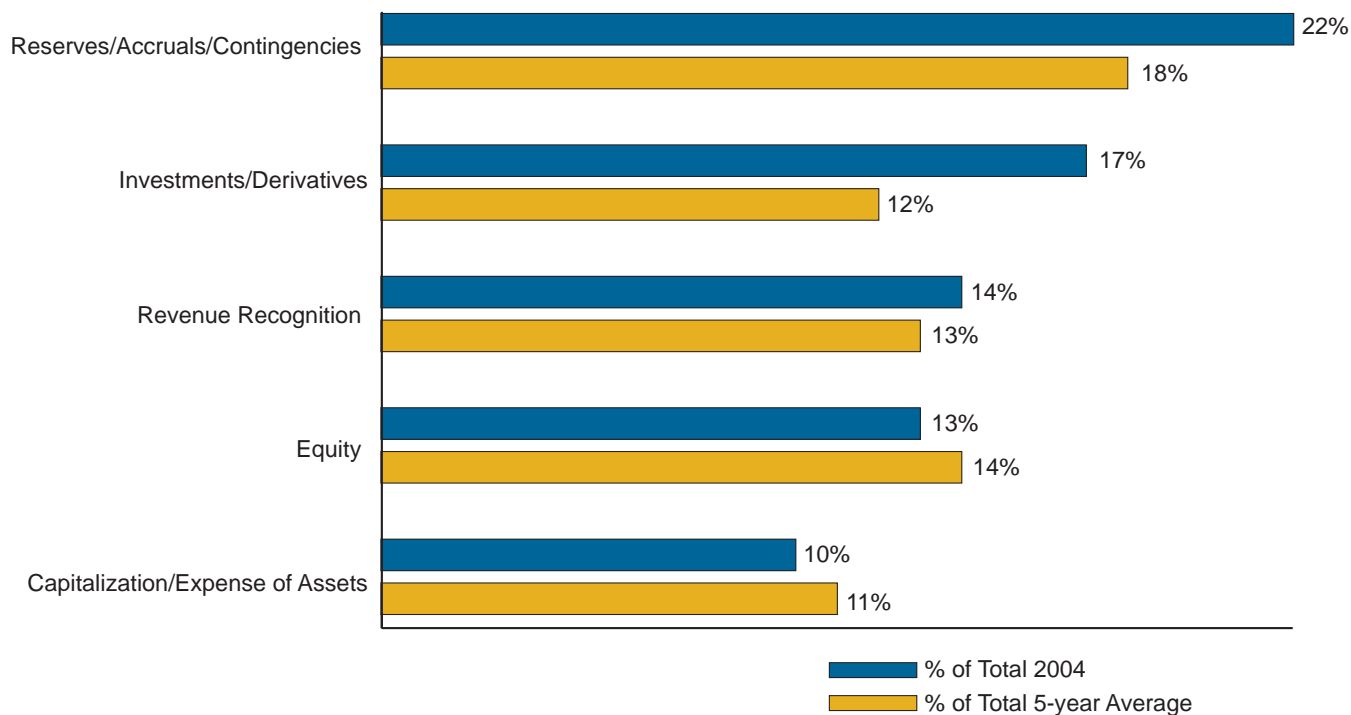


# Finance, Insurance, and Real Estate Industry

### Restatements by Year Filed

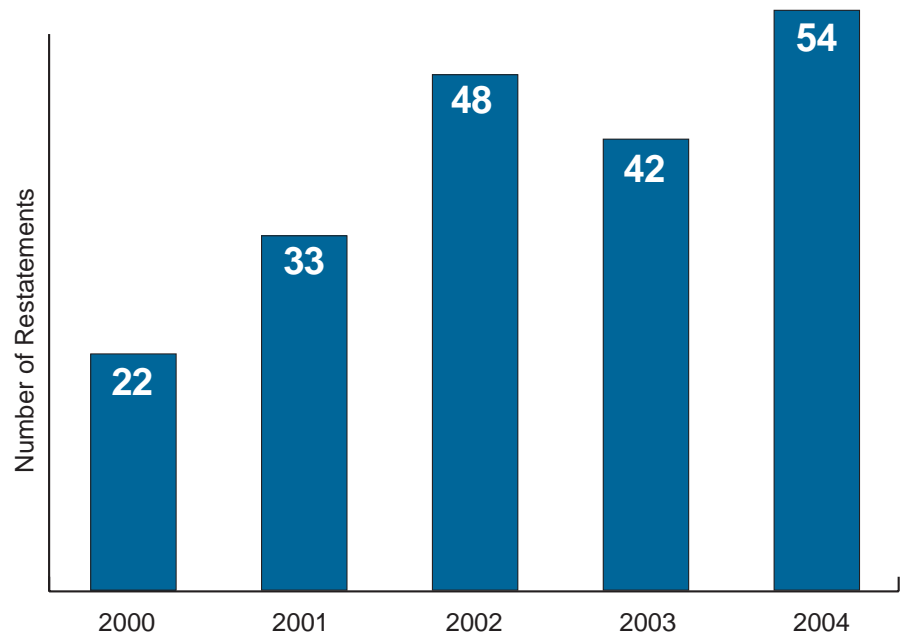


### Top Five Accounting Issues (2000-2004)

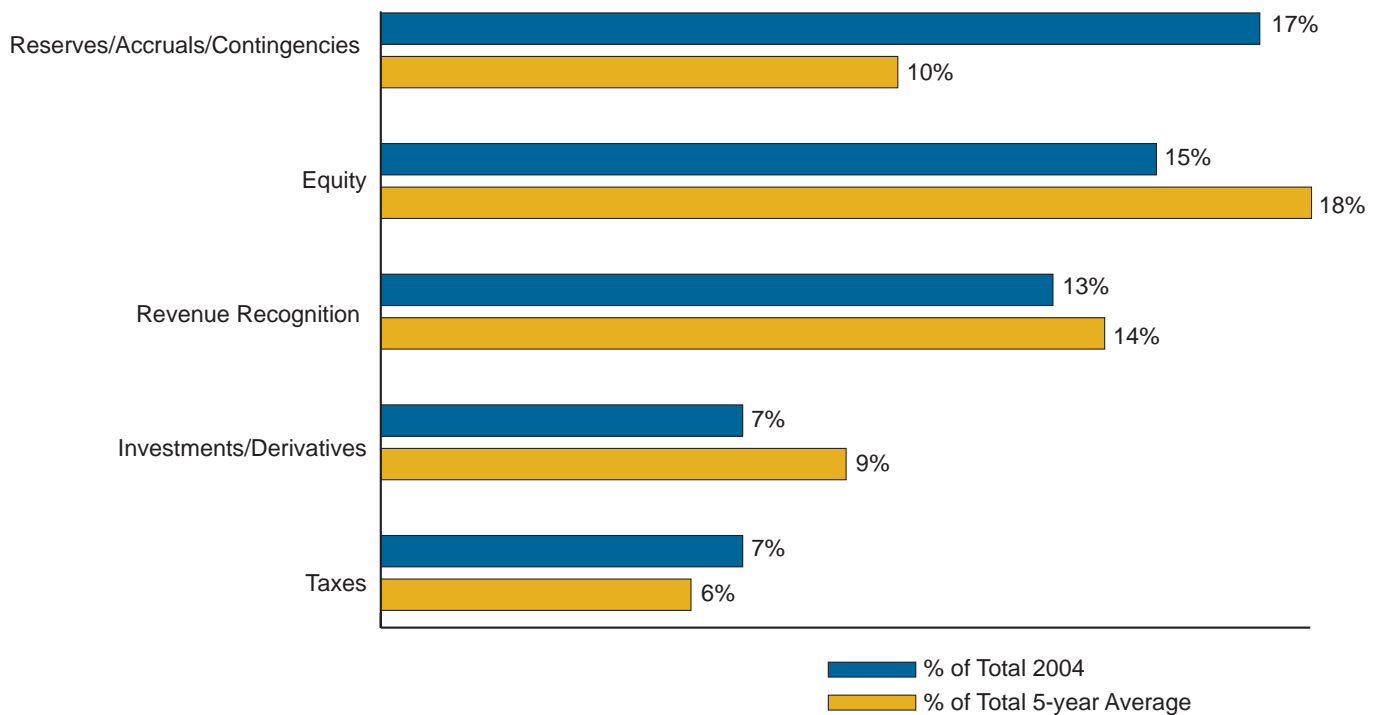


# Transportation, Communications, Electric, Gas, and Sanitary Services Industry

Restatements by Year Filed

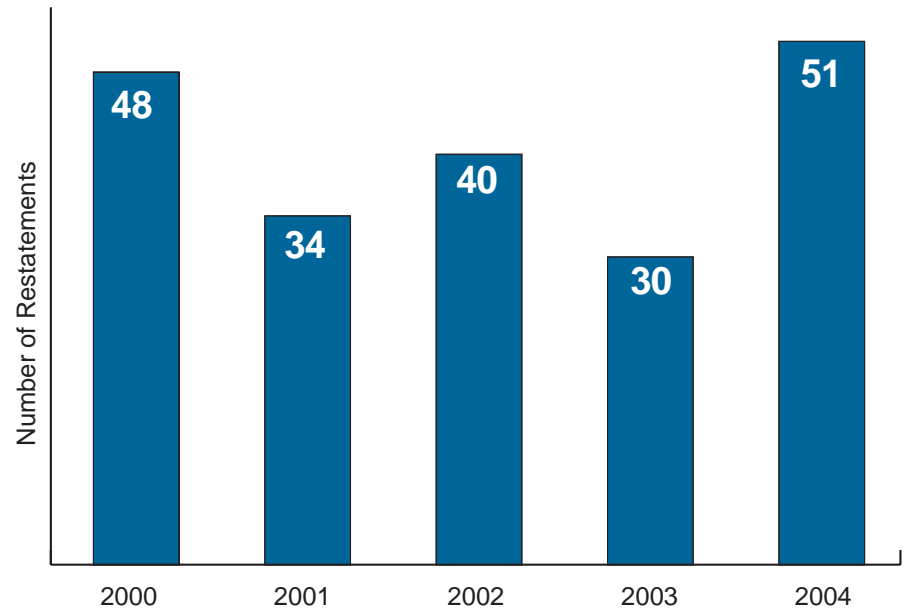


Top Five Accounting Issues (2000-2004)

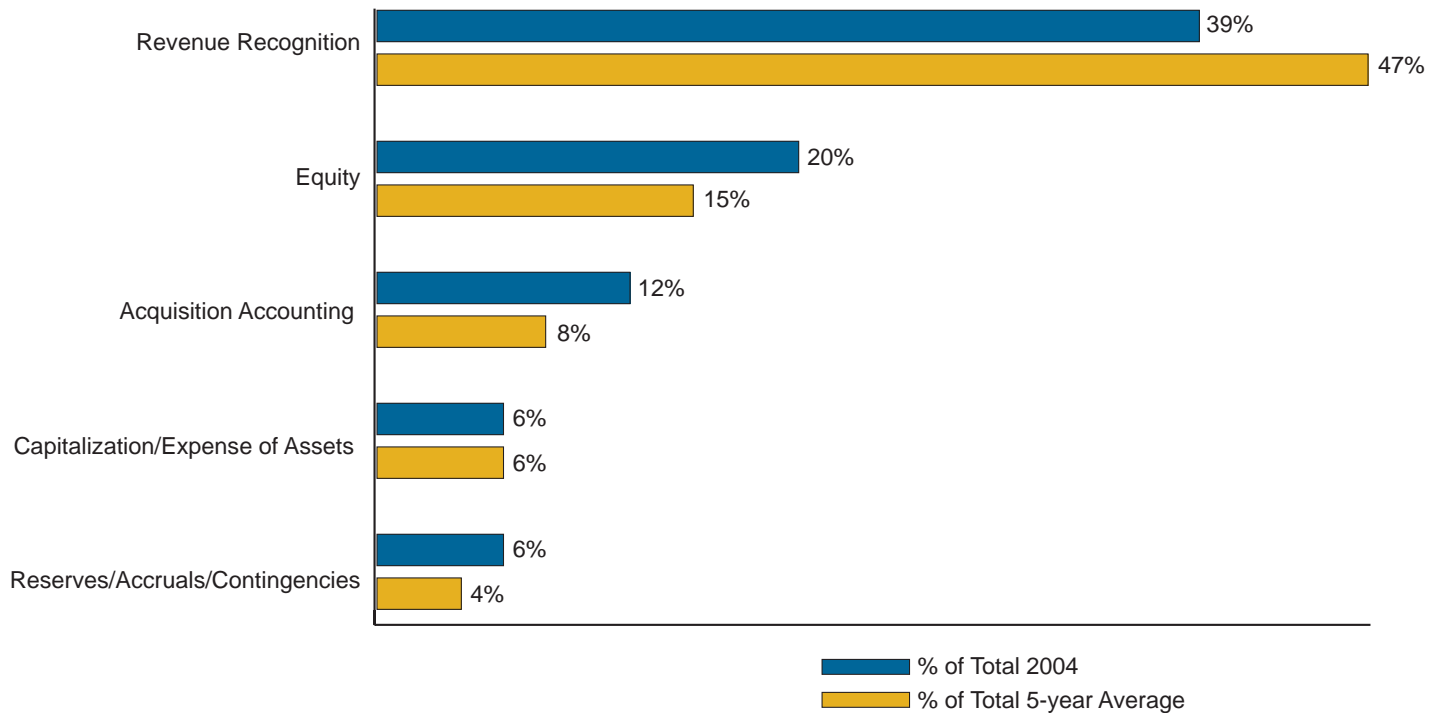


# Software Industry

### Restatements by Year Filed



### Top Five Accounting Issues (2000-2004)



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**Huron Consulting Group is an independent provider of financial and operational consulting services. Huron's experienced and credentialed professionals apply their expertise in accounting, finance, economics, and operations to a wide variety of financially sound and distressed organizations, including Fortune 500 companies, medium-sized businesses, leading academic institutions, healthcare organizations, and the law firms that represent these various organizations.**

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