United States General Accounting Office

GAO

Report to the Chairman, Committee on Banking, Housing, and Urban Affairs, U.S. Senate

October 2002

FINANCIAL STATEMENT RESTATEMENTS

Trends, Market Impacts, Regulatory Responses, and Remaining Challenges

GAO-03-138

Contents

Letter

Letter		1
	Results in Brief	4
	Background	9
	The Number of Restatements Has Grown Significantly and Trends Emerge	14
	Restating Publicly Traded Companies Lost Billions of Dollars in Market Capitalization in the Days and Months Surrounding a Restatement Announcement	24
	Restatements and Accounting Issues Appear to Have Negatively Impacted Investor Confidence	32
	SEC Has Been Investigating an Increasing Number of Cases Involving Accounting-Related Issues	42
	The Growing Number of Accounting Problems in the Corporate Financial Reporting System Have Spurred Reforms	55
	Observations	72
	Agency Comments and Our Evaluation	73

Appendixes

Appendix I:	**Objectives, Scope, and Methodology**	75
	Identifying the Number of and Reasons for Financial Statement Restatements	75
	Determining the Impact of Financial Statement Restatements on Market Values of Restating Companies	77
	Determining the Impact of Financial Statement Restatements on Investor Confidence	84
	Analysis of SEC's Accounting-Related Enforcement Activities	84
	Collecting Information on Current and Proposed Accounting and Financial Reporting Oversight Structures	85
Appendix II:	**Comments from the Securities and Exchange Commission**	86
Appendix III:	**Listing of Financial Statement Restatement Announcements, 1997-June 2002**	88
Appendix IV:	**Case Study Overview**	113
	Business Overview	114
	Restatement Data	114
	Accounting/Auditing Firm	114
	Stock Prices	114
	Securities Analysts' Recommendations	115
	Credit Rating Agency Actions Taken	115
	Legal and Regulatory Actions Taken	116

Appendix V:	**Adelphia Communications Corporation**	117
	Business Overview	117
	Restatement Data	117
	Accounting/Audit Firm	118
	Stock Price	119
	Securities Analysts' Recommendations	120
	Credit Rating Agency Actions	121
	Legal and Regulatory Actions Taken	121
Appendix VI:	**Aurora Foods Inc.**	125
	Business Overview	125
	Restatement Data	125
	Accounting/Audit Firm	126
	Stock Price	126
	Securities Analysts' Recommendations	127
	Credit Rating Agency Actions	128
	Legal and Regulatory Actions Taken	128
Appendix VII:	**Critical Path, Inc.**	134
	Business Overview	134
	Restatement Data	134
	Accounting/Audit Firm	137
	Stock Price	137
	Securities Analysts' Recommendations	139
	Credit Rating Agency Actions	139
	Legal and Regulatory Actions Taken	139
Appendix VIII:	**Enron Corporation**	144
	Business Overview	144
	Restatement Data	144
	Accounting/Audit Firm	147
	Stock Price	148
	Securities Analysts' Recommendations	149
	Credit Rating Agency Actions	150
	Legal and Regulatory Actions Taken	150
Appendix IX:	**Hayes Lemmerz International, Inc.**	152
	Business Overview	152
	Restatement Data	152
	Accounting/Audit Firm	153
	Stock Price	153
	Securities Analysts' Recommendations	154
	Credit Rating Agency Actions	155
	Legal and Regulatory Actions Taken	155

Appendix X:	**JDS Uniphase Corporation**	157
	Business Overview	157
	Restatement Data	157
	Accounting/Audit Firm	159
	Stock Price	159
	Securities Analysts' Recommendations	160
	Credit Rating Agency Actions	161
	Legal and Regulatory Actions Taken	161
Appendix XI:	**MicroStrategy Incorporated**	163
	Business Overview	163
	Restatement Data	163
	Accounting/Audit Firm	165
	Stock Price	166
	Securities Analysts' Recommendations	167
	Credit Rating Agency Actions	168
	Legal and Regulatory Actions Taken	168
Appendix XII:	**Orbital Sciences Corporation**	171
	Business Overview	171
	Restatement Data	171
	Accounting/Audit Firm	172
	Stock Price	173
	Securities Analysts' Recommendations	174
	Credit Rating Agency Actions	175
	Legal and Regulatory Actions Taken	175
Appendix XIII:	**Rite Aid Corporation**	176
	Business Overview	176
	Restatement Data	176
	Accounting/Audit Firm	179
	Stock Price	180
	Securities Analysts' Recommendations	182
	Credit Rating Agency Actions	183
	Legal and Regulatory Actions Taken	183
Appendix XIV:	**Safety-Kleen Corporation**	187
	Business Overview	187
	Restatement Data	187
	Accounting/Audit Firm	188
	Stock Price	188
	Securities Analysts' Recommendations	190
	Credit Rating Agency Actions	190
	Legal and Regulatory Actions Taken	190

Appendix XV:	**SeaView Video Technology, Inc.**	192
	Business Overview	192
	Restatement Data	192
	Accounting/Audit Firm	193
	Stock Price	194
	Securities Analysts' Recommendations	195
	Credit Rating Agency Actions	196
	Legal and Regulatory Actions Taken	196
Appendix XVI:	**Shurgard Storage Centers, Inc.**	197
	Business Overview	197
	Restatement Data	197
	Accounting/Audit Firm	198
	Stock Price	198
	Securities Analysts' Recommendations	199
	Credit Rating Agency Actions	200
	Legal and Regulatory Actions Taken	200
Appendix XVII:	**Sunbeam Corporation**	201
	Business Overview	201
	Restatement Data	201
	Accounting/Audit Firm	202
	Stock Price	202
	Securities Analysts' Recommendations	203
	Credit Rating Agency Actions	204
	Legal and Regulatory Actions Taken	204
Appendix XVIII:	**Thomas & Betts Corporation**	207
	Business Overview	207
	Restatement Data	207
	Accounting/Audit Firm	208
	Stock Price	208
	Securities Analysts' Recommendations	211
	Credit Rating Agency Actions	212
	Legal and Regulatory Actions Taken	212
Appendix XIX:	**Waste Management, Inc.**	214
	Business Overview	214
	Restatement Data	214
	Accounting/Audit Firm	216
	Stock Price	216
	Securities Analysts' Recommendations	219
	Credit Rating Agency Actions	219
	Legal and Regulatory Actions	219

Appendix XX:	**Xerox Corporation**	225
	Business Overview	225
	Restatement Data	225
	Accounting/Audit Firm	226
	Stock Price	227
	Securities Analysts' Recommendations	228
	Credit Rating Agency Actions	229
	Legal and Regulatory Actions Taken	229
Appendix XXI:	**Listing of Accounting and Auditing Enforcement Releases (AAER)**	236
Appendix XXII:	**Frequently Cited Violations**	243
Appendix XXIII:	**Side-by-Side of the Existing Corporate Governance and Oversight Structure and the Sarbanes-Oxley Act of 2002**	244
Appendix XXIV:	**GAO Contacts and Staff Acknowledgments**	260
	GAO Contacts	260
	Acknowledgments	260

Glossary

Glossary 261

Tables

Table 1:	Number of Listed Restating Companies as a Percent of Average Listed Companies, 1997-2002	16
Table 2:	Restatement Category Descriptions	22
Table 3:	Summary of Immediate Market Impact on Restating Companies, 1997-2002	26
Table 4:	Restating Companies' Immediate Market Losses Compared with Total Stock Market Capitalization, 1997-2002	27
Table 5:	Summary of Intermediate Market Impact on Restating Companies, 1997-2002	30
Table 6:	Rule 102(e) and Cease and Desist Actions Against CPAs and Accounting Firms, January 2001-February 2002	53
Table 7:	NYSE Rules 472 and 351 and NASD Rule 2711 Changes Affecting Securities Analysts	65
Table 8:	Case Studies	113
Table 9:	Selected Financial Data, 1999–2001	118
Table 10:	Selected Financial Data, 1998-1999	126
Table 11:	Selected Financial Data, 2000-2001	137
Table 12:	Selected Financial Data 1997-2001	147
Table 13:	Selected Financial Data, 1999-2001	153

Table 14: Selected Financial Data, March 2001 158
Table 15: Selected Financial Data, 1997-1999 164
Table 16: Selected Financial Data 1995–1999 172
Table 17: Selected Financial Data, 1997-2000 179
Table 18: Selected Financial Results, 1997–1999 188
Table 19: Selected Financial Data, 2000 193
Table 20: Selected Financial Data, 1998–2001 198
Table 21: Selected Financial Data, 1996 – 1998 202
Table 22: Selected Financial Data, 1996-2000 208
Table 23: Selected Financial Data, 1992-1999 216
Table 24: Selected Financial Data, 1997–2000 226
Table 25: Listing of AAER Cases, January 2001-June 2002 236
Table 26: Accounting and Auditing Related Federal Securities Laws or Rules Violations 243
Table 27: Side-by-Side Comparison of Existing Structure and New Sarbanes-Oxley Structure 245

Figures

Figure 1: Total Number of Restatement Announcements Identified, 1997-2002 15
Figure 2: Percent of Listed Companies Restating, 1997-2002 19
Figure 3: Restatements by Reason, 1997-June 2002 21
Figure 4: Who Prompted Restatements, 1997-June 2002 24
Figure 5: Immediate Market Impact on Market Capitalization of Restating Companies by Restatement Reason, January 1, 1997-March 27, 2002 29
Figure 6: UBS/Gallup Investor Optimism Index, October 1996–August 2002 34
Figure 7: Effect of Accounting Concerns on Investor Confidence in the Stock Market, February 2002–July 2002 36
Figure 8: Equity Mutual Fund Net Flows, June 2001–July 2002 41
Figure 9: SEC Enforcement Process 46
Figure 10: Number of AAERs and Total SEC Enforcement Actions Initiated, 1990-2001 49
Figure 11: Existing System of Corporate Governance and Accounting Oversight Structures 56
Figure 12: Daily Stock Prices for Adelphia, December 1, 2001–May 14, 2002 120
Figure 13: Daily Stock Prices for Aurora, October 1, 1999—October 31, 2000 127
Figure 14: Daily Stock Prices for Critical Path, August 1, 2000-August 31, 2001 138

Figure 15: Daily Stock Prices for Enron, May 1, 2001–June 28, 2002 149
Figure 16: Daily Stock Prices for Hayes, March 1, 2001-December 6, 2001 154
Figure 17: Daily Stock Prices for JDS Uniphase, October 2, 2000–October 31, 2001 160
Figure 18: Daily Stock Prices for MicroStrategy, September 1, 1999–September 29, 2000 167
Figure 19: Daily Stock Prices for Orbital, August 3, 1998–September 29, 2000 174
Figure 20: Daily Stock Prices for Rite Aid, December 1, 1998–December 31, 1999 182
Figure 21: Daily Stock Prices for Safety-Kleen, September 1, 1999-June 9, 2000 189
Figure 22: Daily Stock Prices for SeaView, September 1, 2000–June 28, 2002 195
Figure 23: Daily Stock Prices for Shurgard, May 1, 2001–April 30, 2002 199
Figure 24: Daily Stock Prices for Sunbeam, December 1, 1997–December 31, 1998 203
Figure 25: Daily Stock Prices for Thomas & Betts, April 1, 1999 – April 30, 2000 209
Figure 26: Daily Stock Prices for Thomas & Betts, February 1, 2000–February 28, 2001 211
Figure 27: Daily Stock Prices for Waste Management, May 1, 1997–May 29, 1998 217
Figure 28: Daily Stock Prices for Waste Management, February 1, 1999–February 29, 2000 218
Figure 29: Daily Stock Prices for Xerox, November 1, 2000-June 28, 2002 228

Abbreviations

AAER	Accounting and Auditing Enforcement Release
AICPA	American Institute of Certified Public Accountants
Amex	American Stock Exchange
ASB	Auditing Standards Board
CEO	chief executive officer
CFO	chief financial officer
CPA	certified public accountant
EBITDA	earnings before interest, taxes, depreciation, and amortization

ERISA	Employee Retirement Income Security Act
CRS	Congressional Research Service
FAF	Financial Accounting Foundation
FASB	Financial Accounting Standards Board
FEI	Financial Executive International
GAAP	generally accepted accounting principles
GAAS	generally accepted auditing standards
IPO	initial public offering
IPR&D	in-process research and development
NASD	National Association of Securities Dealers
Nasdaq	National Association of Securities Dealers Automated Quotation
NRSRO	nationally recognized statistical rating organization
NYSE	New York Stock Exchange
OCA	Office of the Chief Accountant
OTC	over-the-counter
PEEC	Professional Ethics Executive Committee
POB	Public Oversight Board
PwC	PricewaterhouseCoopers
RPAF	registered public accounting firm
SAB	staff accounting bulletin
SEC	Securities and Exchange Commission
SECPS	SEC Practice Section
SOP	statement of position
SPE	special purpose entity
SRO	self-regulatory organization
TAQ	trade and quote

United States General Accounting Office
Washington, D.C. 20548

October 4, 2002

The Honorable Paul S. Sarbanes
Chairman, Committee on Banking,
Housing, and Urban Affairs
United States Senate

Dear Mr. Chairman:

A number of well-publicized announcements about financial statement restatements[1] by large, well-known public companies such as Xerox, Enron, and WorldCom have erased billions of dollars of previously reported earnings and raised questions about the credibility of accounting practices and the quality of corporate financial disclosure and oversight in the United States. Industry officials and academics have speculated that several factors may have caused U.S. companies to use questionable accounting practices, including (1) corporate pressure to meet quarterly earnings projections and thus maintain stock prices during and after the market expansion of the 1990s, (2) perverse executive compensation incentives, (3) outdated accounting and rule-based standards, and (4) complex corporate financing arrangements. Industry officials also have testified that public accounting firms' independence has been compromised and that they may have faced some pressure to agree with, or ignore, questionable accounting practices in order to keep some clients' business. Some of these officials added that increased focus and guidance by the Securities and Exchange Commission (SEC or Commission) on accounting issues in the late 1990s may have prompted more companies to restate previously reported financial statements.

You asked us to (1) determine the number of, reasons for, and other trends in financial statement restatements since 1997; (2) analyze the impact of restatement announcements on the restating companies' stock market capitalization; (3) research available data to determine the impact of financial statement restatements on investors' confidence in the existing U.S. system of financial reporting and capital markets; (4) analyze SEC enforcement actions involving accounting and auditing irregularities; and

[1]A financial statement restatement occurs when a company, either voluntarily or prompted by auditors or regulators, revises public financial information that was previously reported. For purposes of this report, the restatement announcement is considered the market event to be measured.

(5) describe the major limitations of the existing oversight structure and steps that have been and are being taken to ensure the integrity of corporate financial disclosures and ongoing challenges.

To identify financial statement restatements, we used Lexis-Nexis, an online periodical database, to search for restatement announcements using variations of the word "restate." We then identified and collected information on 919 financial statement restatements announced by 845 public companies from January 1, 1997, to June 30, 2002, that involved accounting irregularities[2] resulting in material misstatements of financial results. We included only announced restatements that were being made to correct previous material misstatements of financial results. Therefore, our database excludes announcements involving stock splits, changes in accounting principles, and other financial statement restatements that were not made to correct mistakes in the application of accounting standards. While several other studies have used similar methodology, there is no known authoritative restatement list against which to compare the completeness of our list. However, we cross-checked portions of our list with lists compiled by SEC, the Congressional Research Service, and others when this information was available.[3] We also reviewed SEC filings to verify the accuracy of particular restatement announcement dates.

[2]For the purposes of this report, an accounting irregularity is defined as an instance in which a company restates its financial statements because they were not fairly presented in accordance with generally accepted accounting principles (GAAP). This would include material errors and fraud.

[3]While several academic and nonacademic researchers have constructed and maintained their own financial restatement lists, these lists are generally proprietary and are not publicly available.

To determine the immediate impact on stock prices, we analyzed 689 of the 919 restatements that were announced from January 1, 1997, to March 26, 2002, to determine why restatements occurred and collected information on other characteristics of the restatement trends. We excluded 230 cases because (1) they involved stocks not listed on the New York Stock Exchange (NYSE), the National Association of Securities Dealers Automated Quotation (Nasdaq), or the American Stock Exchange (Amex); (2) they involved announcements made after March 26, 2002;[4] or (3) they were missing data for the relevant time period due to trading suspensions, bankruptcies, and mergers, among other things. For each of these 689 cases, we analyzed the company's stock price on the trading day before, the trading day of, and the trading day after the announcement date in order to assess the immediate impact and calculate the change in market capitalization. We also analyzed the intermediate impact (60 trading days before and after the restatement announcement date) for 575 restatements. This calculation required 3 months of trading data before and after the announcement date; therefore, we excluded an additional 114 restatements because the announcement was made after December 31, 2001,[5] the restating companies filed for bankruptcy, or data were missing for the relevant time period. In both the immediate and intermediate calculations, we attempted to adjust for overall market movements, such as the general decline in the stock market since 2000. We also did additional analyses on the cases that were excluded from the immediate and intermediate impact analyses due to missing data to determine the immediate and intermediate impact on market capitalization. We also reviewed survey and other empirical data and obtained the views of industry experts on investor confidence and participation in U.S. capital markets.

To obtain information about the recent enforcement actions SEC has taken to address accounting and auditing irregularities, we collected information on SEC's enforcement process, reviewed available SEC information, and analyzed SEC's enforcement activity involving accounting irregularities

[4]We obtained stock prices from the NYSE Trade and Quote (TAQ) database, a subscription-based database of daily stock data. Our subscription ended in March 2002; therefore, we were only able to include announcements made before March 27 for purposes of our market capitalization impact analysis.

[5]Our TAQ subscription only included stock quotes through March 2002; therefore, the analysis of the intermediate impact on market capitalization includes only companies that announced restatements before December 31, 2001, because the calculation requires stock prices 3 months before the restatement announcement and 3 months after the announcement.

from January 1, 2001, to February 28, 2002. Finally, we reviewed the current and proposed approaches to corporate governance oversight and disclosure in order to determine gaps in oversight and needed reforms. For additional information on our scope and methodology, see appendix I.

We conducted our work in Washington, D.C., between February and September 2002 in accordance with generally accepted government auditing standards.

Results in Brief

While the number of restating companies continues to make up a small percentage of all publicly listed companies annually, the number of restatements due to accounting irregularities grew significantly—about 145 percent—from January 1997 through June 2002. Based on the number of restatements as of June 30, 2002, we expect the increase to exceed 170 percent by the end of the year. The number of financial statement restatements identified each year rose from 92 in 1997 to 225 in 2001. The proportion of listed companies on NYSE, Amex, and Nasdaq identified as restating their financial reports tripled from less than 0.89 percent in 1997 to about 2.5 percent in 2001 and may reach almost 3 percent by the end of 2002. From January 1997 through June 2002, about 10 percent of all listed companies announced at least one restatement. Among the restating companies that we identified, the number of large company restatements had grown rapidly since 1997.[6] The average (median) size by market capitalization of a restating company increased from $500 million ($143 million) in 1997 to $2 billion ($351 million) in 2002.[7] In addition, of the 125 public companies that announced restatements due to accounting irregularities in 2002, 54 were listed on Nasdaq and 53 were listed on NYSE, which generally lists more large companies than any other stock market.[8]

[6]Unless otherwise indicated, we defined a large company as one having over $10 billion in market capitalization, which is the value of a company as determined by the market price of its issued and outstanding common stock (the number of shares outstanding multiplied by the current market price of a share). We found similar results defining a large company as having over $1 billion in total assets.

[7]For the average size, we report the trimmed mean [the average of the sample excluding the largest (by absolute magnitude) 5 percent]. We also report the median values to mitigate the effects of extreme outliers.

[8]In 2002, Nasdaq had 1,200 more companies listed than NYSE. The average market capitalization for NYSE-listed companies was $4.3 billion, and for Nasdaq-listed companies it was $0.7 billion at the end of 2002.

The 845 restating companies we identified had restated their financial statements for many reasons—for example, to adjust revenue, costs or expenses, or to address securities-related issues. From January 1997 to June 2002, issues involving revenue recognition (misreported or nonreported revenue) accounted for almost 38 percent of the 919 announced restatements; revenue recognition was also the primary reason for restatement each year. Finally, in reviewing the restatements, we found different parties can prompt a restatement, including the restating company, an external auditor, or SEC.

The 689 publicly traded companies we identified that announced financial statement restatements between January 1997 and March 2002 lost billions of dollars in market capitalization in the days around the initial restatement announcement. For example, from the trading day before through the trading day after an initial restatement announcement, stock prices of the restating companies that we analyzed fell almost 10 percent on average (market adjusted). We estimate that the restating companies lost about $100 billion in market capitalization, which is significant for the companies and shareholders involved but represents less than 0.2 percent of the total market capitalization of NYSE, Nasdaq, and Amex. However, these losses had potential ripple effects on overall investor confidence and market trends. Restatements involving revenue recognition led to greater market losses than other types of restatements. For example, although restatements involving revenue recognition accounted for 39 percent of the 689 restatements analyzed, over one-half of the total immediate losses were attributable to revenue recognition-related restatements. Although longer-term losses (60 trading days before and after) are more difficult to measure, there is some evidence that restatement announcements appear to have had an even greater negative impact on stock prices over longer periods.

The growing number of restatements and mounting questions about certain corporate accounting practices appear to have shaken investors' confidence in our financial reporting system. Although determining the effect of financial statement restatements and other accounting issues on overall investor confidence is difficult to measure (because so many factors go into making investment decisions), various attempts to measure investor confidence have been made. For example, a UBS/Gallup survey-based index that asks questions aimed at measuring investor confidence indicates that people cited accounting practices as a serious problem and that these practices have negatively impacted securities markets.[9] However, Yale University calculates four survey-based indexes that ask different questions that generally indicate that investor confidence in the markets has been largely unaffected as of June 2002.[10] Other sources such as empirical research studies and academic experts generally suggest accounting issues have negatively affected overall investor confidence and raised questions about the integrity of U.S. markets.

With the increase in the number of restatements due to accounting irregularities, almost 20 percent of SEC's enforcement cases since the late 1990s were for violations resulting from financial reporting and accounting practices. An SEC official said that about half of these enforcement cases involved revenue recognition violations. Of the 150 accounting-related cases brought from January 1, 2001, to February 28, 2002, about 75 percent were brought against public companies or their directors, officers, and employees; the other 25 percent of the cases involved accounting firms and certified public accountants (CPA). To address such violations, SEC has sought a variety of penalties against these companies and individuals, including levying monetary sanctions, issuing cease-and-desist orders, and barring individuals from appearing before SEC or serving as officers or directors in public companies.[11] Slightly more than half of the enforcement proceedings initiated were administrative, involving allegations that a firm or individual had violated GAAP or that an individual had caused a firm or other individuals to act unlawfully. The remainder of the enforcement

[9]The UBS/Gallup Index of Investor Optimism.

[10]The four indexes are (1) One-Year Confidence Index, (2) Buy on Dip Confidence Index, (3) Crash Confidence Index, and (4) Valuation Confidence Index.

[11]SEC does not have the authority to bring criminal enforcement actions against securities law violators. However, SEC can refer these cases to the U.S. Department of Justice.

proceedings initiated were civil judicial actions, usually cases involving securities fraud.

The recent increase in the number and size of financial statement restatements and disclosures of accounting issues and irregularities underlying these restatements have raised significant questions about the adequacy of the current system of corporate governance and financial disclosure oversight. In addition to public companies, their auditors, and SEC, investors rely on a variety of parties for oversight and financial information, including stock markets, securities analysts, and credit rating agencies, all of which have roles in the corporate governance system or provide information to the investing public. However, recent events have raised concerns about the roles played by each of these parties. In response, Congress, the President, SEC, the exchanges, and others have begun taking action to attempt to strengthen corporate governance and financial reporting. Most significantly, on July 30, 2002, the Sarbanes-Oxley Act was enacted.[12] The act addresses many of these concerns, including strengthening corporate governance and improving transparency and accountability to help ensure the accuracy and integrity of the financial reporting system. In addition, the act authorizes additional funding for SEC, which as we reported in March 2002, has faced staffing and workload imbalances that have challenged its ability to fulfill its mission.[13] Effectively managing its human capital resources, technology, and processes is likely to remain a challenge for SEC in the future, especially for regulatory activities involving oversight of public company disclosures and financial fraud-related enforcement.

[12]Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204.

[13]U.S. General Accounting Office, *SEC Operations: Increased Workload Creates Challenges*, GAO-02-302 (Washington, D.C.: Mar. 5, 2002).

The Sarbanes-Oxley Act addresses many of the concerns we have raised over the years involving corporate governance, auditor independence, regulation and oversight of the accounting profession, and SEC's resource limitations.[14] However, the fundamental principles of setting up the right incentives, providing adequate transparency, and ensuring full accountability are even more relevant as the new structure is being established. SEC must help ensure that corporate managers are held accountable for corporate financial reporting. Likewise, effective governance structures composed of highly qualified individuals are key to the success of any organization and system on which others must rely. In this regard, keys to successful implementation of this new structure include ensuring that (1) highly qualified individuals are appointed to the Public Company Accounting Oversight Board (Board) and that they fully embrace the principles articulated in the act and the need for reform, (2) the Board provides active leadership and ongoing input to the profession, (3) the Board ensures meaningful audit standards are adopted, and (4) the Board punishes wrongdoers appropriately.

We requested comments on the entire draft from the Chairman, SEC. SEC provided written comments. SEC noted that the report was thorough and reiterated several of our major findings. SEC stated that it is fully committed to the rule-making and other activities needed to fully implement "the letter and spirit of the [Sarbanes-Oxley] Act." SEC added that it is particularly mindful of our observations concerning the selection of members and implementation of the Board. SEC also expressed its commitment—given the additional resources that the Sarbanes-Oxley Act identified as necessary for SEC to carry out its responsibilities and its internal resolve—to meet its ongoing human capital, technology, and process challenges. We have reprinted SEC's written comments in appendix II, and we discuss them in greater detail near the end of this letter.

[14] U.S. General Accounting Office, *The Accounting Profession: Major Issues: Progress and Concerns*, GAO/AIMD-96-98 (Washington, D.C.: Sept. 24, 1996); *Protecting the Public Interest: Selected Governance, Regulatory Oversight, Auditing, Accounting, and Financial Reporting Issues*, GAO-02-438T (Washington, D.C.: Mar. 5, 2002); *Protecting the Public Interest: Considerations for Addressing Selected Regulatory Oversight, Auditing, Corporate Governance, and Financial Reporting Issues*, GAO-02-601T (Washington, D.C.: Apr. 9, 2002); *Accounting Profession: Oversight, Auditor Independence, and Financial Reporting*, GAO-02-742R (Washington, D.C.: May 3, 2002); and GAO-02-302.

We also obtained comments from officials at the National Association of Securities Dealers (NASD), Nasdaq, NYSE, and Amex on selected excerpts of a draft of this report. Finally, we obtained comments from officials at several of the companies selected as case studies in this report. We have incorporated their comments as appropriate.

Background

The Securities Act of 1933 (Securities Act) and the Securities Exchange Act of 1934 (Exchange Act) establish the principle of full disclosure, which requires that investors receive sufficient information on investment opportunities to help them make informed investment decisions. The Securities Act requires that a public offering of securities be registered with SEC. Although the Securities Act establishes a full disclosure regulatory requirement applicable to the initial offering of securities, it does not require any periodic reporting thereafter. The Exchange Act, designed to facilitate subsequent trading of securities by investors, requires public companies to comply with certain periodic reporting requirements to ensure an ongoing flow of meaningful information that investors can use in making investment decisions. To fulfill its mission, SEC also reviews certain offering documents and periodic filings of selected companies to determine whether they contain the required information.

The self-regulatory structure is premised on the concept of corporate governance. Officers and directors of a public company are responsible for ensuring that the preparation and content of financial statements fully and accurately depict the company's financial condition and the results of its activities. However, the board of directors—particularly the audit committee—and the public company's internal auditor play important roles in oversight. The primary role of the corporate board of directors is to oversee the management of a company and to protect the interests of its shareholders. Internal auditors offer another internal check on the operations and control systems within a company. Independent external auditors are to provide an additional safeguard in connection with all public companies and many other entities.

All public companies registered with SEC are required to have their financial statements audited by an independent public accountant. Although a public company's management is responsible for the preparation and content of the public company's financial statements, the independent external auditor is responsible for auditing the financial statements in accordance with generally accepted auditing standards (GAAS). The purpose of the audit is to provide reasonable assurance that a company's financial statements are fairly presented in all material respects in accordance with GAAP. As we testified before the Senate Committee on Banking, Housing, and Urban Affairs on March 5, 2002, for over 70 years, the public accounting profession, through its independent audit function, has played a critical role in enhancing a financial reporting process that facilitates the effective functioning of our capital markets.[15] Independent audits give the public confidence that issuers' financial statements are reliable and contribute to an efficient market for public companies' securities. This sense of confidence can exist only if reasonable investors perceive auditors as independent and expert professionals who have neither interests in the entities they are auditing nor other conflicts of interest. Investors and other users expect auditors to bring integrity, independence, objectivity, and professional competence to the financial reporting process, and to prevent the issuance of misleading financial statements.

SEC has traditionally relied on the private sector to set standards for financial reporting and independent audits, retaining largely oversight responsibilities. As mentioned earlier, the Securities Act and the Exchange Act require companies that sell securities in the United States to register with SEC and make periodic filings disclosing the companies' financial status and changes in condition. Although the registration process requires the accuracy of the facts represented in the registration statements and prospectuses, this registration process does not guarantee accuracy. As part of its oversight of the registration and filing process, SEC staff review selected issuers' filings for compliance with accounting and disclosure requirements. Disclosure documents include

- registration statements for new offers of securities,
- proxy materials sent to shareholders before an annual meeting,

[15] GAO-02-483T.

- annual reports to shareholders,
- quarterly statements of financial condition,
- current reports on significant occurrences,
- documents concerning tender offers, and
- filings related to mergers and acquisitions.

SEC's review of corporate filings may be a full review, a full financial review, or monitoring of certain filings for specific disclosure items.[16] SEC's Division of Corporation Finance (CorpFin) is responsible for this function and reviews filings on a selective basis. CorpFin performs full reviews of financial information, public disclosures, and related filings, as appropriate, for substantially all registrations of initial public offerings (IPO) of securities. As reported in our March 2002 report on SEC's operations, during the 1990s, the number of IPOs grew substantially, which contributed to a 59 percent increase in corporate filings from 1991 to 2000.[17] Full reviews are also required for all current reports of a change in a registrant's certifying accountant. Experienced staff select or "screen" other filings for review on the basis of certain financial and qualitative screening criteria. SEC's goal in 2001 was to perform a full financial review—a review of the companies' financial statements, related footnotes, and management's discussion and analysis of financial condition and results of operations—of about one-third of all public companies' annual reports.[18] Earlier this year, we reported that SEC reviewed half that amount in 2001. Finally, using screening criteria, experienced staff may select other filings for monitoring, which involves reviewing a specific portion of the filing.

[16]A full review involves an in-depth examination of the accounting, financial, and legal aspects of an issuer's filing. A full financial review involves an in-depth accounting analysis of an issuer's financial statements and management's discussion and analysis or business plan disclosure.

[17]GAO-02-302.

[18]In 2001, 14,060 annual reports were filed with SEC.

The stock exchanges and markets, which are self-regulatory organizations (SRO)[19] whose registrations are approved by SEC under the Exchange Act, also have an oversight role. A stock exchange or market establishes listing standards, which are minimum quantitative and qualitative requirements that companies must meet for their stock to be eligible for initial and continued listing for trading. Listing standards prescribe the corporate governance structures and accounting and auditing regulations that companies listed on a stock exchange or market are expected to follow. For example, listing requirements generally address conflicts of interest by corporate insiders, the composition of audit committees, and shareholder approval of corporate actions. The large exchanges also require their listed companies to have boards of directors with an independent audit committee to, among other duties, oversee the company's internal controls over financial reporting processes.

Securities analysts, through their research and stock recommendations, play an important role in providing investors with information that may affect investment decisions. Analysts typically research the current and prospective financial condition of certain publicly traded companies and make recommendations about investing in those companies' securities based on their research. This research is likely to include all publicly available information about the company and its businesses, including financial statements; research on the company, industry, product or sector; and public statements by and interviews with executives of the company and its customers and suppliers. The analysis and opinions are generally presented on a relative basis and compare companies' performance within a sector or industry.

[19]SROs are industry organizations responsible for regulating their member broker-dealers. Broker-dealers are firms that buy or sell stocks, bonds, and other securities for customers or for themselves.

Credit ratings produced by rating agencies are widely circulated; many investors rely on these ratings to make investment decisions. These ratings include opinions about the creditworthiness of certain public companies and their financial obligations, including bonds, preferred stock, and commercial paper. The credit ratings that result from analyses of this information can affect securities markets in a number of important ways, including an issuer's access to and cost of capital, the structure of financial transactions, and the ability of certain entities to invest in certain rated obligations. According to SEC, the importance of credit ratings in securities markets has increased significantly as markets have become more complex. Although rating agencies, as a matter of policy, may rate the debt of certain large corporate issuers, any company can hire a rating agency to rate its debt before the debt is issued. Credit rating agencies rely on a variety of public and nonpublic information, including company presentations, audited and interim financial statements, and other relevant industry materials. Pursuant to the Investment Advisers Act of 1940, as amended, (Advisers Act),[20] Nationally Recognized Statistical Rating Organizations (NRSRO)[21] register as investment advisers, are required to have an adequate basis for their ratings, and are prohibited from having undisclosed conflicts with respect to the ratings.

[20]Subject to certain exemptions, the Investment Advisers Act defines "investment adviser as any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities," 15 U.S.C. § 80b-2(a)(11)(2000). Generally, only advisers who have at least $25 million of assets under management or advise a registered investment company must register with SEC. The act prohibits fraud, imposes fiduciary duties on advisers with respect to their advice, requires advisers to maintain certain books and records, and gives SEC the authority to examine those registered as investment advisers for compliance with the Act.

[21]Although the term NRSRO was originally adopted by SEC solely for determining capital charges on different grades of debt securities under the Commission's net capital rule, Rule 15c3-1 under the Exchange Act, its use has expanded over the years. It generally applies to credit rating agencies that SEC recognizes as NRSROs based on reviews about the rating organization's operations, position in the marketplace, and other criteria. Currently, there are three NRSROs—Moody's Investors Service, Inc.; Fitch, Inc.; and the Standard and Poor's Division of the McGraw-Hill Companies, Inc.

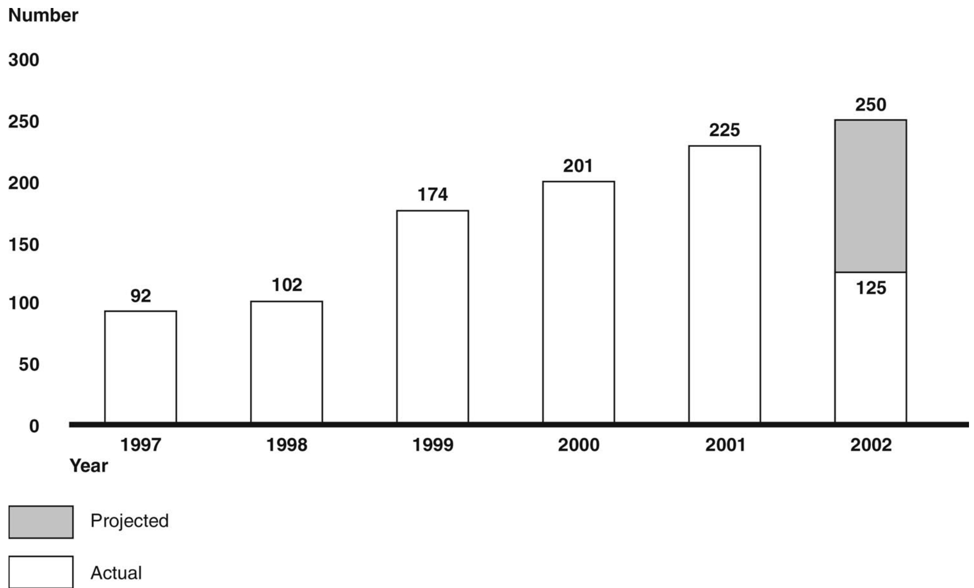
The Number of Restatements Has Grown Significantly and Trends Emerge

Although on a yearly basis the number of companies restating their financial statements due to accounting irregularities makes up only a small percentage of publicly listed companies, we found that the number of restatements has grown significantly since 1997. In addition, of the 919 announced restatements we identified (app. III), the percentage of large companies restating has grown rapidly since 1997. Whether large or small, companies restate their financial results for varying reasons, but we identified revenue recognition as the most frequently cited reason for restating. Finally, in reviewing these restatement announcements, we found that different parties can prompt a restatement, including the restating company's management, an external auditor, or SEC.

The Number of Restatements Has Grown, but Restating Companies Make Up a Small Portion of Listed Companies

The number of announcements of financial statement restatements has increased significantly each year, rising from 92 in 1997 to 225 in 2001—an increase of approximately 145 percent (fig. 1). Based on the number of restatement announcements we have identified for the first half of 2002, we project the increase since 1997 to rise to more than 170 percent by the end of 2002.

Figure 1: Total Number of Restatement Announcements Identified, 1997-2002



Notes: Includes restatement announcements by public companies traded on the over-the-counter (OTC) bulletin board and on Pink Sheets. Also, note that the 2002 figure is estimated based on 125 restatement announcements collected through June 2002.

Source: GAO's analysis of relevant press releases and SEC filings.

While the average number of companies listed on NYSE, Nasdaq, and Amex decreased 20 percent from 9,275 in 1997 to 7,446 in 2002, the number of listed companies restating their financials increased from 83 in 1997 to a projected 220 in 2002 (a 165 percent increase) (table 1). Based on these projections, the proportion of listed companies restating on a yearly basis is expected to more than triple from 0.89 percent in 1997 to almost 3 percent by the end of 2002. In total, the number of restating companies is expected to represent about 10 percent of the average number of listed companies from 1997 to 2002.

Table 1: Number of Listed Restating Companies as a Percent of Average Listed Companies, 1997-2002

Year	Number of companies listed	Number of listed companies restating	Percent of listed companies restating
1997	9,275	83	0.89%
1998	9,179	94	1.02
1999	8,739	151	1.73
2000	8,534	171	2.00
2001	7,902	195	2.47
2002	7,446	220	2.95
1997-2002	8,494	845	9.95

Notes: The number of listed companies (NYSE-, Nasdaq-, and Amex-listed companies) for each year 1997 to 2002 are based on monthly averages. The number of listed companies for 2002 is as of June 30. The total number of listed companies restating in 2002 is estimated based on the 110 unique companies identified through June 2002. Companies that restated more than one time are counted only once. Also, note that the number of listed companies restating differs from the total number of restatements because not all companies that restated were listed on NYSE, Nasdaq, or Amex. For example, in 1997 there were 92 restatements; however, 8 were attributed to companies trading OTC and 1 company restated twice, leaving 83 listed companies identified as restating.

Source: GAO's analysis of restatement announcements and Nasdaq.

A number of research reports also found that financial statement restatements had increased since 1997. Each of the reports used somewhat different search methodologies and included slightly different types of restatements but arrived at similar conclusions. Financial Executives International (FEI) and M. Wu (2001) identified 523 restatements from 1997 to 2000 and noted a significant increase in restatements from 1997 to 1998 and continuing increases from 1999 to 2000.[22] The Huron Consulting Group (2002) identified 993 financial statement restatements from 1997 to 2001; it also found that the number of restatements increased substantially from 1997 to 2001.[23] The former SEC chief accountant and several accounting

[22]FEI and M. Wu, "Quantitative Measures of the Quality of Financial Reporting," (Morristown, NJ: Financial Executives International Research Foundation, 2001).

[23]Huron Consulting Group, "A Study of Restatement Matters," (Chicago: Huron Consulting Group, 2002).

fellows also found an increase in the number of financial statement restatements from 1997 to 1999.[24]

The Percentage of Large Companies Restating Has Grown Since 1997

Until recently, restatements due to accounting irregularities were seen as primarily affecting small companies and the technology industry. However, for the restatements we identified, the number of large companies restating their financial statements has increased significantly. Based on total assets, large companies as a percent of the total restating companies have increased from about 25 percent in 1997 to over 30 percent in 2001.[25] Generally, for the past 2 years, the number of large and small companies restating has been equal. Likewise, the average (median) market capitalization of a restating company has grown from about $500 million ($143 million) in 1997 to $2 billion ($351 million) in 2002.[26] While the average size of listed companies increased about 60 percent from 1997 to 2002, the average size of companies restating their financials grew over 300 percent. (The median grew about 146 percent.) Moreover, as the average size of U.S. companies fell during the period from 1999 to 2002, the average size of restating companies continued to increase.

Another indication that the size of companies restating has increased is the growing number of NYSE-listed companies identified as restating. This result is attributable to the fact that more large companies are listed on NYSE than the other stock markets.[27] Nasdaq has on average 62 percent more companies listed on its market than NYSE. Historically more Nasdaq-listed companies restated due to accounting irregularities than NYSE-listed companies.[28] For example, in 1997, 21 NYSE-listed companies had announced restatements; by 2001, the number had increased to 80, an

[24]Turner, L., J. Dietrich, K. Anderson, and A. Bailey, "Accounting Restatements," Working Paper, (Washington, D.C.: U.S. Securities and Exchange Commission, 2001).

[25]For the purpose of this discussion, we define a large company as having over $1 billion in total assets.

[26]We did not attempt to test the relationship between where a company is listed (NYSE, Nasdaq, Amex, or other) and its likelihood of restating.

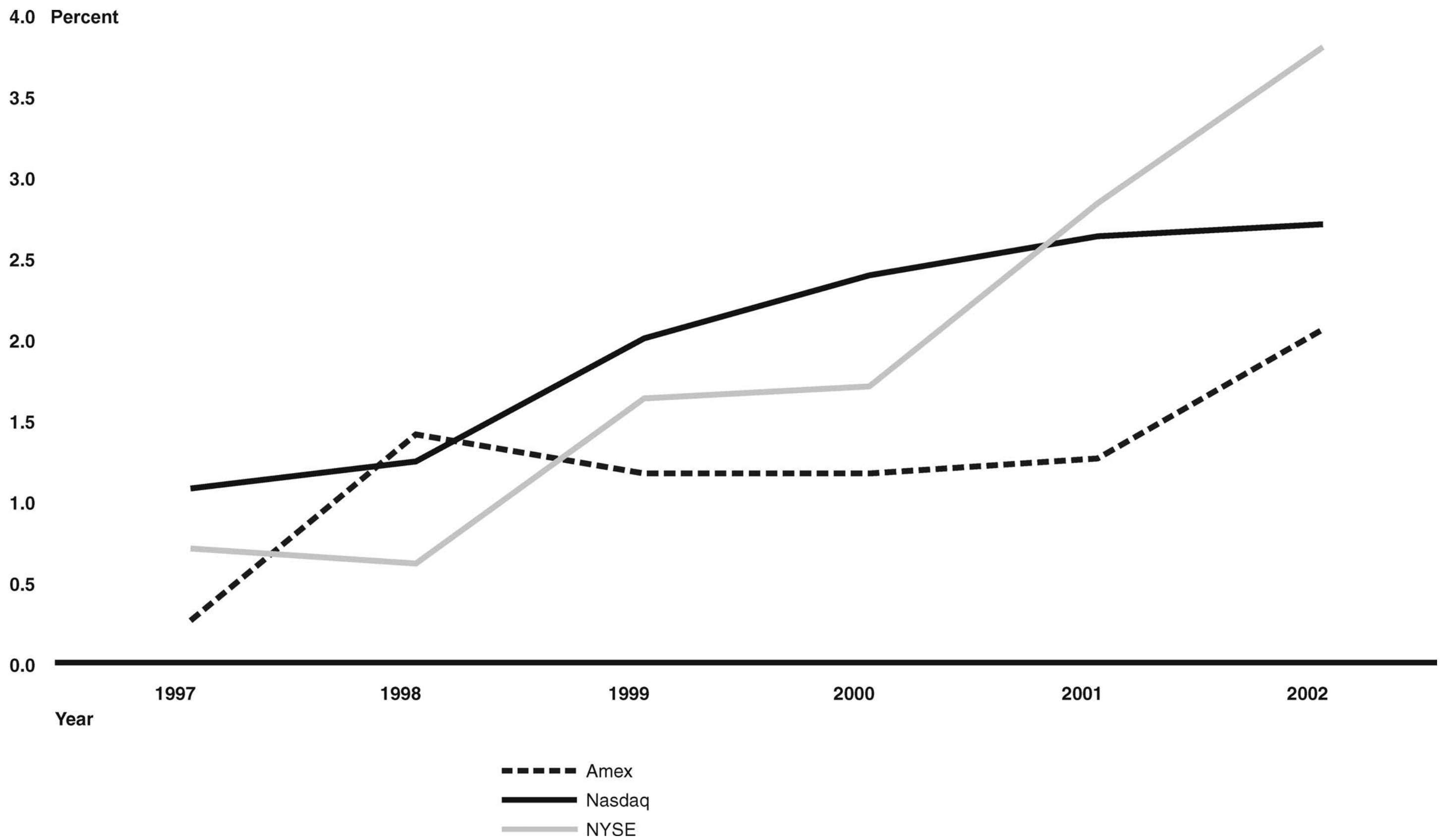
[27]The average market capitalization of Nasdaq-listed companies restating their financial statements was $766 million while the average for NYSE-listed companies restating their financial statements was $6.2 billion. This indicates that NYSE companies restating due to accounting irregularities are bigger than their Nasdaq counterparts.

[28]Includes Nasdaq National Market System- and Small Cap venue-listed companies.

almost fourfold increase. During the same time, the number of Nasdaq-listed companies announcing restatements almost doubled from 61 to 113. Also during the same time, the number of Amex-listed companies restating increased from two to eight. However, during the first half of 2002, the 125 restatements attributable to companies listed on NYSE and Nasdaq were almost evenly split at 53 and 54, respectively, even though more companies are listed on Nasdaq. The remaining restating companies were listed on Amex.

As figure 2 illustrates, for the announced restatements we identified, the percentage of all NYSE-, Nasdaq-, and Amex-listed companies that restated due to accounting irregularities increased between 1997 and June 2002. In 1997, less than 1 percent of NYSE-listed companies restated for accounting irregularities. However, since about 2000, the percentage of NYSE-listed companies restating has risen at a faster rate that the percentage of Nasdaq- and Amex-listed companies restating, rising to over 3.5 percent of all NYSE listings in 2002. Moreover, beginning in 2001, the percentage of NYSE-listed companies restating exceeded the percentage of Nasdaq-listed companies. Based on the number of restatements announced for the first half of 2002, we project that the percentage of NYSE-listed companies restating will continue to increase faster than the percentage of companies listed on Nasdaq and Amex throughout 2002.

Figure 2: Percent of Listed Companies Restating, 1997-2002



Note: The 2002 figures are estimated based on data collected through June 2002.

Source: GAO's analysis of selected NYSE, Nasdaq, and Amex data on listed companies.

Revenue Recognition Is the Leading Reason for Restatements

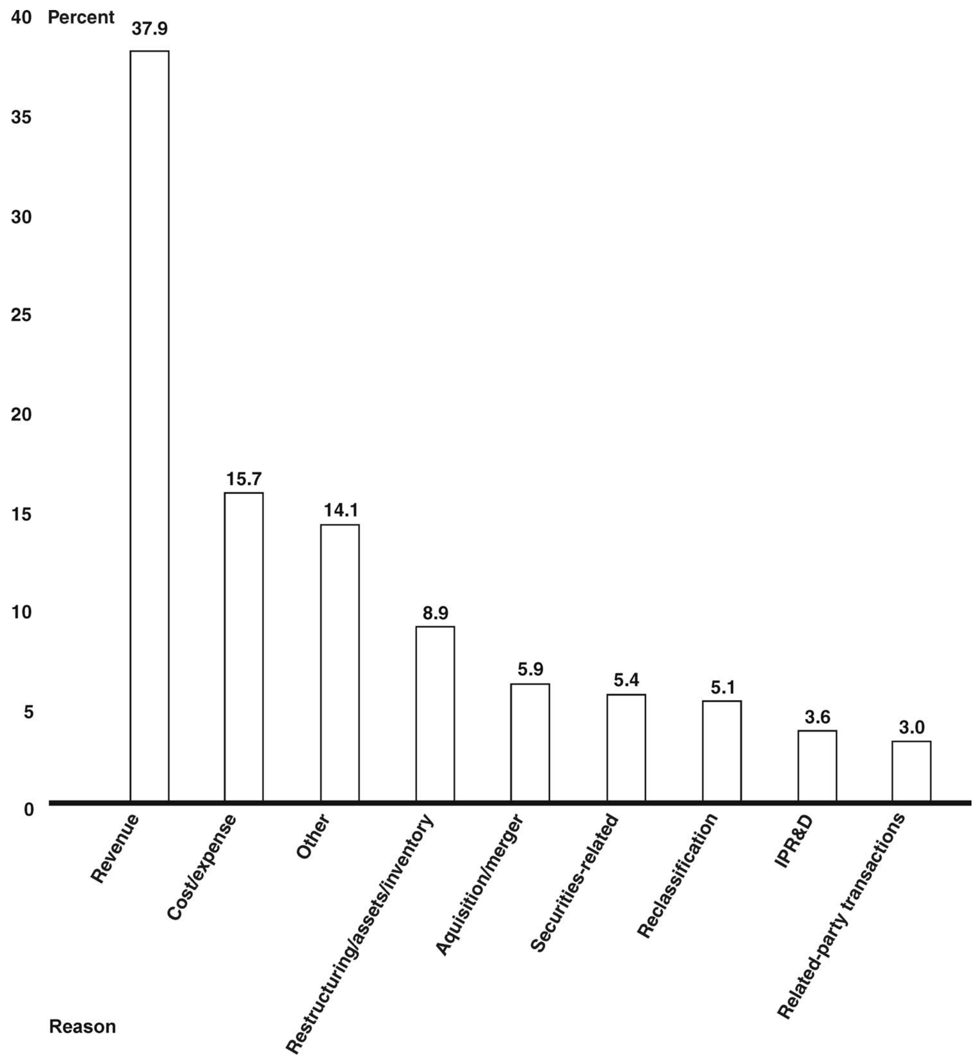
Although public companies restate their financials for a variety of reasons, revenue recognition was the reason for 38 percent of the 919 announced restatements we identified (fig. 3).[29] Restatements due to revenue recognition generally include a company recognizing revenue sooner or

[29]We classified each of the 919 announced restatements we identified into one of nine categories: revenue recognition; cost or expense; acquisitions and mergers; in-process research and development; reclassification; related-party transactions; restructuring, assets, or inventory; securities related; and other. This classification process involved some judgment and other researchers could interpret certain restatements differently.

later than would have been allowed under GAAP or recognizing questionable or fictitious revenue. For example, some of the companies identified as restating because of revenue recognition had prematurely recognized revenue. Cost or expense-related issues were the next most frequently identified reason, accounting for almost 16 percent of all the restatements we identified. (See table 2 for a description of each reason.) These types of restatements include instances of improper cost recognition, tax issues, and other cost-related improprieties that led to financial misstatements. For example, the recent WorldCom announcement that it had incorrectly recorded certain operating expenses as capital expenditures, effectively overstating net income, was considered a cost or expense-related restatement.[30]

[30] WorldCom Press Release, "WorldCom Announces Intention to Restate 2001 and First Quarter 2002 Financial Statements," (Clinton, Miss., June 25, 2002).

Figure 3: Restatements by Reason, 1997-June 2002



Note: Our database includes announced restatements that were being made to correct previous material misstatements of financial results. Therefore, our database excludes announcements involving stock splits, changes in accounting principles, and other financial statement restatements that were not made to correct mistakes in the application of accounting standards.

Source: GAO's analysis of initial restatement announcements due to accounting irregularities.

Table 2: Restatement Category Descriptions

Category	Description
Acquisitions and mergers	Restatements of acquisitions or mergers that were improperly accounted for or not accounted for at all. These include instances in which the wrong accounting method was used or losses or gains related to the acquisition were understated or overstated. This does not include in-process research and development or restatements for mergers, acquisitions, and discontinued operations when appropriate accounting methods were employed.
Cost or expense	Restatements due to improper cost accounting. This category includes instances of improperly recognizing costs or expenses, improperly capitalizing expenditures, or any other number of mistakes or improprieties that led to misreported costs. It also includes restatements due to improper treatment of tax liabilities, income tax reserves, and other tax-related items.
In-process research and development	Restatements resulting from instances in which improper accounting methodologies were used to value in-process research and development at the time of an acquisition.
Other	Any restatement not covered by the listed categories. Cases included in this category include restatements due to inadequate loan-loss reserves, delinquent loans, loan write-offs, or improper accounting for bad loans and restatements due to fraud, or accounting irregularities that were left unspecified.
Reclassification	Restatements due to improperly classified accounting items. These include restatements due to improprieties such as debt payments being classified as investments.
Related-party transactions	Restatements due to inadequate disclosure or improper accounting of revenues, expenses, debts, or assets involving transactions or relationships with related parties. This category includes those involving special purpose entities.
Restructuring, assets, or inventory	Restatements due to asset impairment, errors relating to accounting treatment of investments, timing of asset write-downs, goodwill, restructuring activity and inventory valuation, and inventory quantity issues.
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 mistakes or improprieties that led to misreported revenue.
Securities related	Restatements due to improper accounting for derivatives, warrants, stock options and other convertible securities.

Note: We excluded announcements involving stock splits, changes in accounting principles, and other financial statement restatements that were not made to correct mistakes in the application of accounting standards.

Source: GAO.

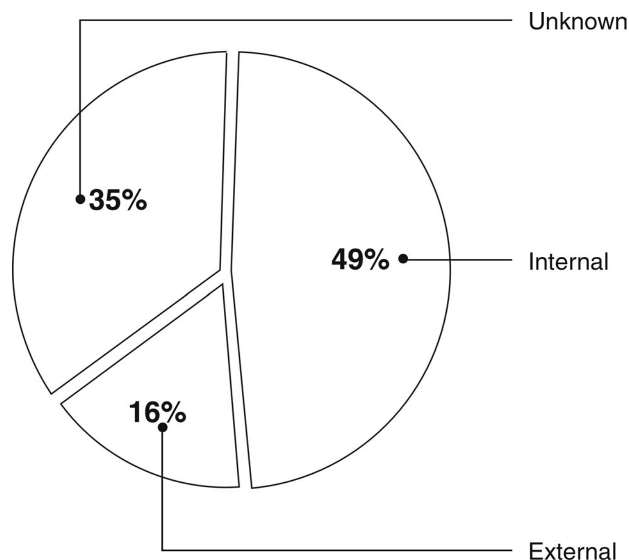
Although most of the other categories account for only a small percent of total restatements, we found that securities-related restatements, which made up about 6 percent of the total, increased significantly during the first half of 2002. Securities-related restatements, which can stem from errors and misstatements involving derivatives, warrants, stock options, and other convertible securities, increased from 4.6 percent of restatements in 2001 to 12.4 percent of restatements in the first half of 2002. Moreover, we identified more securities-related restatements in the first half of 2002 than for all of 2001. Enron is one of the most notable companies whose restatements were based on securities-related reasons (as well as others). Many industry experts have questioned how Enron accounted for certain derivative transactions, and some experts asserted that Enron improperly valued sales of certain securities products to inflate its reported revenues.[31]

A Variety of Parties Can Prompt Restatements

A number of parties, such as the restating company, an independent auditor, SEC, or others can prompt financial statement restatements. As shown in figure 4, we found that about 49 percent of the 919 announced restatements reported the restating company as the party responsible for recognizing the previous misstatements. However, external parties may have been involved in discovering some of these misstatements, even if the companies may have not made that information clear in their restatement announcements or SEC filings. For example, Critical Path, Inc. (Critical Path), a technology company, announced that it was launching an investigation into accounting irregularities but did not mention in its initial announcement that its external auditor had raised concerns about the company's accounting treatment of certain transactions before the company announced that it had launched an investigation. SEC, the external auditor, or some other external party (for instance, the Federal Reserve or the media) was identified as prompting the restatement in 16 percent of the restatements we identified. In 35 percent of the restatements, we were not able to determine who prompted the restatement because the announcement or SEC filing did not clearly state who actually discovered the misstatement of the company's prior financial results.

[31]See appendixes V through XX for an in-depth discussion of Enron and 15 other restating companies. Our case study approach is explained in appendix IV.

Figure 4: Who Prompted Restatements, 1997-June 2002



Source: GAO's analysis of GAO identified initial restatement announcements due to accounting irregularities.

Restating Publicly Traded Companies Lost Billions of Dollars in Market Capitalization in the Days and Months Surrounding a Restatement Announcement

In the 3 trading days surrounding the initial announcement of a restatement, the stock prices of most of the restating publicly traded companies that we analyzed decreased by almost 10 percent and, in total, these companies lost more than $100 billion in market capitalization. While these losses are large in dollar terms, they are negligible compared with the total market capitalization of the overall stock market. We found that restatements involving revenue recognition accounted for more than half of these losses. We also found evidence that the stock prices of the restating companies remained depressed for longer periods, although other factors may have contributed to this.

On Average, Stock Prices Fell in the Days Surrounding the Initial Restatement Announcement

We estimated that for the 689 cases we analyzed from January 1, 1997, to March 26, 2002, the stock price of a company making an initial restatement announcement fell by almost 10 percent (market-adjusted), on average, from the trading day before to the day after the announcement (the immediate impact).[32] Unadjusted losses in the market capitalization of companies issuing initial restatement announcements totaled over $100 billion, ranging from about $4.6 billion in 1997 to about $28.7 billion in 2000. As table 3 shows, even when the losses were adjusted for general movements in the overall market, restating companies lost $95.6 billion in market capitalization. Although we attempted to control for general market movements over each 3-trading day window in an effort to isolate the impact of the announcement, other factors may have influenced the stock price of a retating company during this period.

[32]We used the average holding period abnormal return, a market-adjusted performance measure calculated from a specified date before (for example, 1 trading day) to a specified date after (for example, 1 trading day) the initial announcement of a financial statement restatement, to capture the average impact of a restatement announcement on the stock price of a restating company. In calculating this average, we first calculated the holding period abnormal return (the unexpected return due to the announcement) for each restating company's stock over the company-specific time period. We then averaged the holding period abnormal returns for all restatement announcements. Details of these calculations are provided in appendix I.

Table 3: Summary of Immediate Market Impact on Restating Companies, 1997-2002

Calendar year or period	Average holding period abnormal return (percent)	Total unadjusted loss in market capitalization (dollars in billions)	Total market-adjusted loss in market capitalization (dollars in billions)	Number of restatement announcements analyzed
1997	-10.6 %	$4.6	$3.2	80 of 92
1998	-14.0	20.6	21.3	87 of 102
1999	-9.6	19.7	18.4	145 of 174
2000	-10.6	28.7	26.3	152 of 201
2001	-5.6	19.3	20.4	181 of 225
2002	-9.6	7.4	6.0	44 of 125
1997-2002	-9.5	100.2	95.6	689 of 919

Notes: The average holding period abnormal returns were statistically different from zero at the 1-percent level of significance for all periods. We excluded 230 cases for a variety of reasons, including cases that involved companies that were not listed on NYSE, Nasdaq, or Amex; cases that involved initial restatement announcements made after March 26, 2002; and cases that involved missing data resulting from trading suspensions, delistings, bankruptcies, and mergers. Data for 2002 are through March 27. Numbers may not add up due to rounding.

Source: GAO's analysis of Nasdaq, NYSE TAQ , and SEC data.

Compared with the total market capitalization of publicly traded companies listed on NYSE, Nasdaq, and Amex, our estimate of the 3-day losses in the market capitalization of restating companies remained below 0.2 percent per year with no clear trend over time (table 4). Our finding that losses as a percentage of market capitalization appear relatively small is not surprising considering the short duration of our analysis. We chose this 3-trading day window to focus, as much as possible, on the restatement to the exclusion of other factors. Later in this report, we examine losses over a longer period as well as the effects of restatements on overall market confidence.

Table 4: Restating Companies' Immediate Market Losses Compared with Total Stock Market Capitalization, 1997-2002

Calendar year	Total market capitalization of listed companies (dollars in billions)	Total unadjusted loss in market capitalization of restating companies (dollars in billions)	Total unadjusted loss as a percent of total market capitalization (percent)
1997	$11,600	$4.6	0.04%
1998	13,600	20.6	0.15
1999	17,600	19.7	0.11
2000	16,100	28.7	0.18
2001	14,700	19.3	0.13
2002	14,900	7.4	0.05

Notes: We excluded 230 cases for a variety of reasons, including cases that involved companies that were not listed on NYSE, Nasdaq, or Amex; cases that involved initial restatement announcements made after March 26, 2002; and cases that involved missing data resulting from trading suspensions, delistings, bankruptcies, and mergers. Data for 2002 are through March 27. The total market capitalization of the listed companies is calculated based on January 1998 month-end stock data for 1997, year-end stock data for 1998 to 2001, and March month-end stock data for 2002.

Source: GAO's analysis of Nasdaq, NYSE TAQ, and SEC data.

We also conducted a separate immediate impact analysis on the 230 announcements that were excluded from our primary analysis due to missing TAQ data from January 1997 through June 2002. This analysis was limited to a simple assessment of the unadjusted losses in market capitalization due to restatement announcements. Ninety-one of these cases involved companies that had stock traded on the OTC bulletin board or Pink Sheets, and 71 involved companies that issued restatements after the initial cutoff date of March 26, 2002. Of the 230 cases, we were able to obtain historical stock price information from Nasdaq's Web site for 202 of these, each involving a different company.[33] On average, the market capitalization of these companies dropped by approximately 5 percent from the trading day before through the trading day after the announcement. Our estimate of unadjusted loss in the market capitalization for these 202 companies issuing initial restatement announcements suggested that an additional $14 billion was lost in the 3 trading days around the initial restatement announcement from 1997 to 2002.

[33]Of the 28 restating companies for which we were unable to find stock price information, 12 were acquired by or merged with another company, 4 filed for bankruptcy or closed, and in 2 cases trading was suspended for an extended period of time.

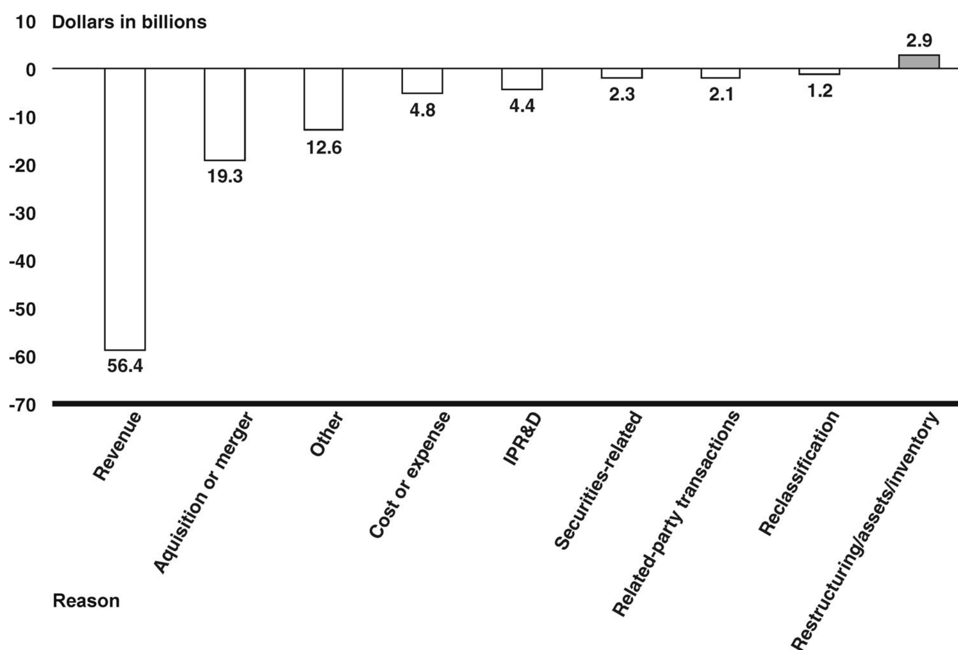
Restatements Involving Revenue Recognition Led to Relatively Greater Losses

We found that announcements involving revenue recognition totaled over $56 billion, or more than half, of the $100 billion in market capitalization that restating companies lost in the 3 trading days around the initial announcement (fig. 5). Of the 689 cases analyzed, revenue recognition was the most frequently cited reason for restating (39 percent).[34] While restatements attributed to the acquisition and merger category accounted for only 6 percent of the 689 restatements analyzed, they accounted for $19 billion or almost 20 percent of losses. However, the second most frequently cited reason for restating, improper or questionable accounting for costs or expenses (14 percent), totaled only about 4.8 percent, or about $4.8 billion, of total market capitalization lost.

Conversely, we found that announcements involving restructuring, asset impairment, and inventory issues resulted in an overall increase of $2.9 billion in market capitalization. This increase was largely driven by the positive market response to two restatements, one by MCI Communications Corporation in 1998 and another by Kimberly-Clark Corporation in 1999. Both of these restatements related to the timing of restructuring charges and led to increases in earnings and collectively resulted in a $4.7 billion increase in market value. However, with the exception of these two restatements, the general market response for restatements falling into this category was negative—a loss of $1.8 billion.

[34]This analysis is based on 689 restatements analyzed. Our previous discussion on restatement reasons included all 919 restatements.

Figure 5: Immediate Market Impact on Market Capitalization of Restating Companies by Restatement Reason, January 1, 1997-March 27, 2002



Notes: Our database includes announced restatements that were being made to correct previous material misstatements of financial results. Therefore, our database excludes announcements involving stock splits, changes in accounting principles, and other financial statement restatements that were not made to correct mistakes in the application of accounting standards.

Source: GAO's analysis of initial restatement announcements, NYSE TAQ, and SEC data.

Restatement Announcements Appeared to Have Some Longer-Term Impact on the Market Capitalization of Restating Companies

Our analysis of 575 of the 919 restatement announcements showed that companies announcing restatements lost billions of dollars in market capitalization and, on average, the stock price of a company making an initial restatement announcement fell by 18 percent (market-adjusted), from 60 trading days before through 60 trading days after the announcement (the intermediate impact). We found that, during this 6-month time frame, the total market capitalization loss of restating companies more than doubled to almost $240 billion (table 5). On a market-adjusted basis, we estimated that these losses totaled almost $190 billion. However, it is important to note that as we considered longer event time frames, we increased the possibility that other factors and events may have impacted a restating company's stock price. For example, although AOL Time Warner (AOL) lost market capitalization in the immediate days

surrounding its 1997 restatement announcement, we estimated the intermediate impact on AOL to be a $24.3 billion gain due primarily to news of the potential acquisition of CompuServe. The intermediate impact analysis does not control for these types of market factors, and as a result, any event that occurs during this time period is attributed to the restatement announcement. In 1997, the AOL market capitalization increase was large enough to produce an overall positive change in our estimate of the intermediate impact on market capitalization for 1997, although the average holding period abnormal return was negative. Appendix I provides additional details and limitations of these measures.

Table 5: Summary of Intermediate Market Impact on Restating Companies, 1997-2002

Calendar year or period	Average holding period abnormal return (percent)	Total unadjusted gain (loss) in market capitalization (dollars in billions)	Total market-adjusted gain (loss) in market capitalization (dollars in billions)	Number of restatement announcements analyzed
1997	-22.8%	$27.6	$14.0	72 of 92
1998	-44.6	(19.1)	(40.1)	72 of 102
1999	-14.7	5.8	(26.5)	130 of 174
2000	-19.9	(114.9)	(73.5)	133 of 201
2001	-6.2	(138.5)	(62.0)	168 of 225
2002	N/A	N/A	N/A	0 of 125
1997-2002	-18.2	(239.1)	(188.1)	575 of 919

Note 1: The average holding period abnormal return was statistically different from zero at the 1-percent level of significance for each period except for 2001. The average holding period abnormal return for 2001 was statistically different from zero at the 10-percent level. We excluded 344 cases for a variety of reasons, including cases that involved companies that were not listed on NYSE, Nasdaq, or Amex; cases that involved initial restatement announcements made after March 26, 2002; and cases that involved missing data resulting from trading suspensions , delistings, bankruptcies, and mergers. Data for 2002 are through June.

Note 2: N/A means not applicable.

Source: GAO's analysis of initial restatement announcements, NYSE TAQ, and SEC data.

As requested, we also analyzed the impact of 114 announcements that were part of the 689 cases included in the immediate impact but were excluded from the intermediate impact calculation for a number of reasons. Of these 114 cases, we excluded 44 cases that occurred in 2002 because we did not have enough data to perform the 60-trading day calculations. Of the 70 remaining cases, we were able to obtain information on 60 of these, each involving a different company. In 25 of the cases, the company filed for bankruptcy protection within a reasonably short period of time following

the restatement announcement. In 17 of the cases, the company continued as an independent concern; and in all but 4 of these cases, the company was delisted from NYSE, Nasadq, or Amex for failure to meet minimum listing standards. In the remaining 18 cases, the company either was acquired by or merged with another company.

We analyzed the market capitalization impact of a restatement on the 25 companies that filed for bankruptcy and the 17 companies that continued as independent concerns (42 companies in all). On average, the market capitalization of these companies dropped by over 80 percent in the months surrounding the restatement announcement. We calculated the market capitalization of these firms to be approximately $37.4 billion 60 trading days prior to the restatement announcement and $9.3 billion 1 trading day prior to the restatement announcement. Trading was suspended within 60 trading days following the restatement announcement for the stocks of companies in all but 4 of these cases, and we estimated that the market capitalization of these companies was $1.4 billion when their stocks were suspended. Of the firms that continued as independent concerns, their market capitalization was approximately $0.2 billion roughly 3 months after the restatement announcement. Thus, an additional $37 billion may have been lost following the restatement announcement for these 42 companies.[35] Enron was one of the companies that was included in this analysis. By our estimates, Enron accounted for over 80 percent of the losses.

We also conducted a separate intermediate impact analysis on the additional 230 announcements that were excluded from our primary analysis due to missing TAQ data. This analysis was again limited to a simple assessment of the unadjusted losses in market capitalization due to restatement announcements. We excluded 71 cases that occurred in 2002 because the restatements occurred after the initial cutoff date of March 26, 2002, and we could not locate data for 25 other companies, leaving 134 cases. We estimated that the market capitalization of these 134 companies dropped over 10 percent, on average, from 60 trading days before, through 60 trading days after the announcement. However, we calculated that the market capitalization of these firms increased by $2.3 billion during this 6-month time frame. This was primarily due to a positive gain of over

[35]Our calculation assumes the market capitalization of the bankrupt companies went to zero.

$7 billion by At Home Corporation, which restated in 1999.[36] Omitting At Home Corporation, we estimated that an additional $5.1 billion was lost following restatement announcements not captured in the initial analysis.

Restatements and Accounting Issues Appear to Have Negatively Impacted Investor Confidence

Not only do restatement announcements appear to affect company stock prices, but some evidence suggests that these announcements and the questions they raise about certain corporate accounting practices may negatively impact overall investor confidence. Investor confidence is difficult to quantify because it cannot be measured directly and because investors consider a variety of factors when making an investment decision. Nevertheless, we identified several survey-based indexes that used a variety of methods to measure investor optimism and empirical work by academics and financial experts. A periodic UBS/Gallup survey-based index aimed at gauging investor confidence conducted since 1996, found that as of June 2002 investor confidence was at an all-time low due to concern over corporate accounting practices (even lower than the period just after September 11, 2001). According to another index, that asks different questions, investor confidence levels were largely unaffected by the September 11 terrorist attacks and that the current direction of investor confidence is unclear. However, a number of academicians found that investors generally believe that the growing number of restatements is symptomatic of a larger, more pervasive problem and that this belief has had a negative impact on investor confidence. Interviews with various experts in the field also suggest that the growing number of financial statement restatements has hampered overall investor confidence. Although a variety of factors contribute to changes in mutual fund flows, recent flow activity may also indicate that investor confidence has been negatively affected.

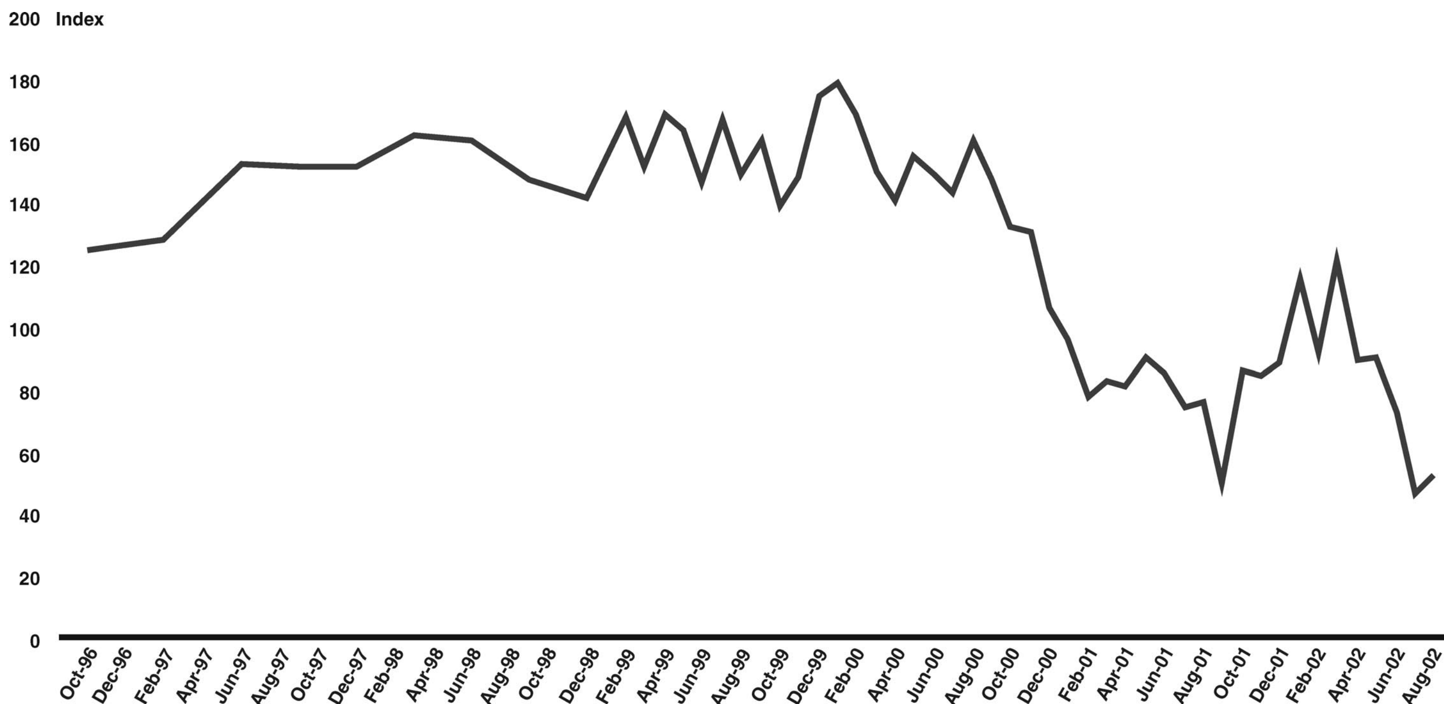
[36]This understates the intermediate loss to shareholders due to restatements since it has now come to light that At Home's stock price appeared to be artificially inflated during 1999 and 2000. During a 10-month investigation, New York State Attorney General's Investor Protection Bureau uncovered evidence that suggested a Merrill Lynch & Company analyst gave strong investment ratings to specific companies while privately denigrating them. The New York State Attorney General alleged these ratings were biased and distorted in an attempt to secure or maintain contracts for its investment banking services. At Home Corporation was one of the companies whose stock price benefited from these alleged conflicted recommendations. By the end of 2001, its stock price had fallen from $86 (60 days after the restatement announcement) to less than a penny a share. Thus, our results are skewed since our analysis captures only the period in which At Home's stock price was artificially inflated but not the period corresponding to the dramatic fall in price.

UBS/Gallup Index of Investor Confidence Reveals Negative Impact of Accounting Concerns on Investor Confidence

The UBS/Gallup Index of Investor Optimism[37] suggests that overall investor confidence has declined significantly since September 2000 and has fallen below the prior record low of 50 set in September 2001 (fig. 6). Between its inception in late 1996 and September 2000, the Index fluctuated around 150. After a dramatic decline from about September 2000 through February 2001 (attributed to a variety of causes, notably the decline in the stock market and the protracted litigation involving the presidential election), the Index stabilized somewhat around a value of 85 during the last quarter of 2001. Following a peak of 121 in March 2002, the Index declined 62 percent to an all-time low of 46 in July 2002. Overall optimism rose slightly in August 2002 to 52, following 3 months of steep declines.

[37]The UBS/Gallup Poll of Investor Attitudes determines a monthly Index of Investor Optimism. The Index, composed of "personal" and "economic" dimensions, yields an overall estimate of investor confidence. The personal element asks investors (defined as any private household with at least $10,000 in investable assets, or nearly 40 percent of all U.S. households) how confident they are about increasing their income and achieving investment goals. The economic dimension poses questions about macroeconomic influences such as unemployment and overall stock market performance. A positive result indicates optimism, while negative result denotes pessimism. In a statistical study of the poll's accuracy, Lawrence Klein, a Nobel Laureate in Economics and Professor at the University of Pennsylvania, endorsed the indicator as "at least as good as and probably better, in terms of accuracy, than the competing [indexes]."

Figure 6: UBS/Gallup Investor Optimism Index, October 1996–August 2002

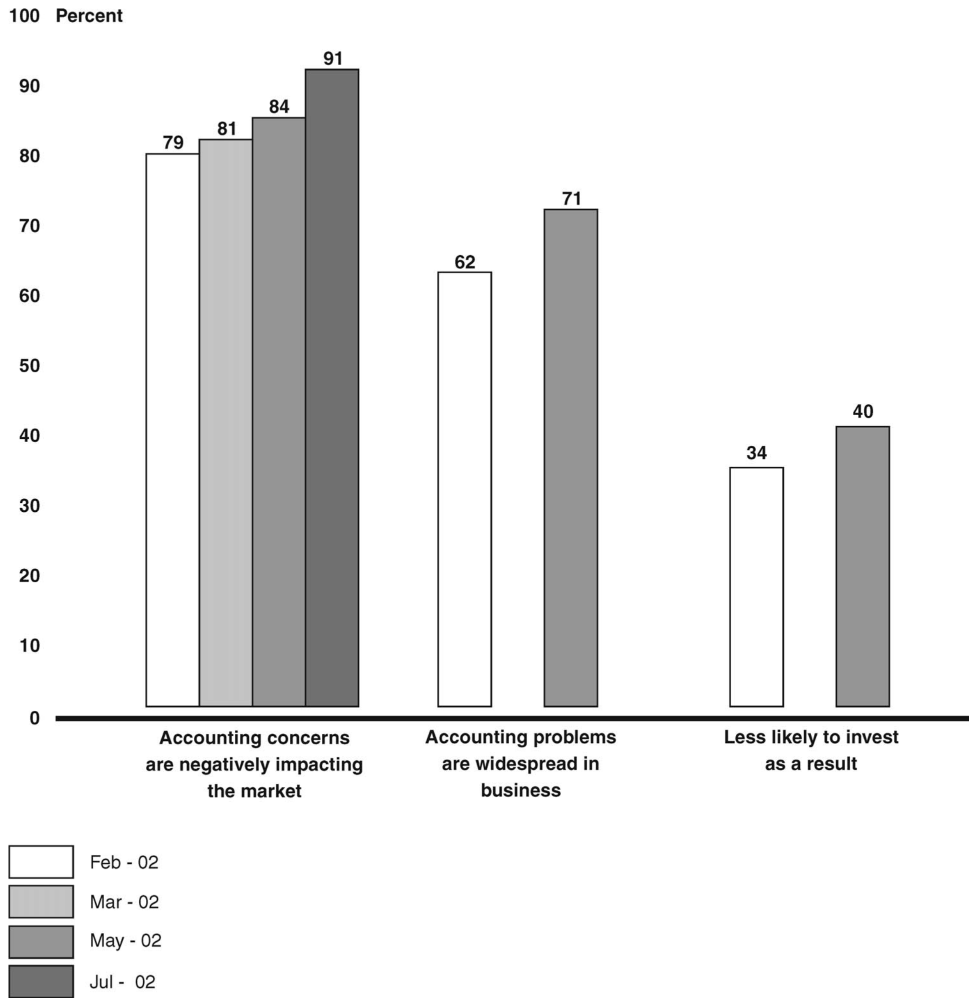


Source: UBS/Gallup.

While investors have cited a number of reasons for the decline in the investor optimism index, the surveys show that since February 2002 the leading concern has been the negative impact of questionable accounting practices on the market. Other reasons identified by a significant proportion of all the investors polled included (1) the general economic condition in the United States, (2) the war on terrorism, and (3) the Israeli-Palestinian conflict. However, these reasons consistently lagged behind and were ultimately surpassed by questionable accounting practices. By July 2002, 91 percent of all investors surveyed felt that accounting issues were negatively impacting the market, up from 79 percent in February (fig. 7). Likewise, in May 2002, 71 percent believed accounting problems were widespread, up from 62 percent in February. Moreover, 40 percent of those interviewed in July 2002 said that they were less likely to invest in equities as a result of questionable accounting practices, up from 34 percent in February 2002.

Although U.S. securities markets are influenced by a variety of factors, the results of the July 2002 survey may suggest that resolving corporate accounting issues could significantly improve the outlook for U.S. markets. For example, when investors were asked what changes would have an extremely large impact on improving financial market conditions, the most frequent response was a healthier economic environment (38 percent). The next three items on the list were (1) strict prison sentences for corporate managers who commit fraud (37 percent), (2) new SEC regulations to address questionable accounting practices (34 percent), and (3) new federal guidelines for ethical standards among corporate managers (31 percent).

Figure 7: Effect of Accounting Concerns on Investor Confidence in the Stock Market, February 2002–July 2002



Note: Questions about the widespread nature of accounting problems and whether investors were less likely to invest were only asked in February and May.

Source: UBS/Gallup.

At Least One Notable Expert Finds Stock Market Confidence Virtually Unaffected

The International Center for Finance at the Yale School of Management calculates four indexes that are based on survey questions directed to both individual and institutional investors.[38] The indexes are based on the following survey questions:

- One-Year Confidence Index - "How much of a change in percentage terms do you expect to see in the Dow Jones Industrial Average [Dow] for the next year?"
- Buy on Dip Confidence Index - "If the Dow dropped 3 [percent] tomorrow, how would the Dow move the day after tomorrow?"
- Crash Confidence Index - "What do you think is the probability of a catastrophic stock market crash in the United States in the next [6] months?"
- Valuation Confidence Index - "Are stock prices in the [United States] too low, too high, or about right when compared with measures of true fundamental value?"

The results of the surveys reveal that although investors believe the market is overvalued, they generally trust that market valuations will increase and that, if they fall, they will rise again. Although these confidence indexes do not directly measure the impact of earnings restatements on investor confidence, they suggest general confidence in the market. Another indication of this enduring confidence is the current price-to-earnings ratio, which was valued at more than the historical average as of June 2002.

We focused on the three indexes that most directly measure investor confidence. The first Yale index is the One-Year Confidence Index, which indicates that institutional investor confidence has increased steadily from November 2001 to June 2002, rising from 72 percent to 83 percent, while individual investor confidence held steady around 89 percent. However, this index may capture only investors' sentiment about the 30 blue-chip stocks that comprise the Dow and not about the entire market. The results could be interpreted as reflecting only investors' belief that companies comprising the Dow are relatively free of financial statement restatements and thus confident about only this subset of the market.

[38]These indexes have been released semiannually since 1989 and monthly since July 2001.

The second Yale index is the Buy on Dip Confidence Index, which yields somewhat conflicting results. The results suggest that individual investor confidence was at 79 percent in January 2002 and declined to 69 percent by June 2002. However, this index finds that during the same period, institutional investor confidence remained steady at around 60 percent. This implies a divergence in opinion between individual and institutional investors but it is unclear what this difference means for overall confidence in the stock market and how confidence has been impacted by financial statement restatements. However, these findings appear to suggest that developments during 2001 and 2002 had some effect on individual investors' confidence but no real effect on institutional investors' confidence.

The third Yale index is the Crash Confidence Index, which suggests that investors' confidence has been consistently low, less than 50 percent, for both individual and institutional investors. However, once again the trend in the data suggests a divergence between institutional and individual investors. For example, results suggest that individual investors' belief that there will be no stock market crash in the next 6 months has gradually declined since 1989. However, this index finds that during this same period, results revealed no such trend for institutional investors, with the exception of a large drop after September 11. Since that date, confidence that the stock market will not crash has risen slightly for both institutional and individual investors. This increase in confidence could reflect the belief that the market has underperformed over the last 2 years and that investors do not expect prices to fall significantly from their present lows.

Other Empirical Evidence and Interviews Suggest a Negative Impact on Investor Confidence

One study has attempted to quantify the loss in investor confidence correlated with earnings restatements, finding a statistically significant decline. The study measured the "earnings response coefficient" of individual firms before and after their restatements.[39] The earnings response coefficient indirectly measures how responsive shareholders are to earnings information by relating a company's positive earnings announcements to a positive effect on the company's share price. This study found that prior to a restatement, a statistically significant relationship existed between quarterly earnings announcements and share prices. After the restatement, however, an earnings announcement showed

[39] M. Wu, "Earnings Restatements: A Capital Market Perspective," Stern School of Business Working Paper (New York University, January 2002).

no significant effect on share price, indicating that the market no longer trusted the company's information about its earnings and demonstrating a loss of investor confidence.

According to several academic experts, there have been significant repercussions as a result of earnings restatements, including a decline in trust in both the accounting profession and corporate management. Despite the fact that U.S. financial information is viewed as more complete than similar information anywhere else in the world, most of the academicians we contacted raised concerns about the quality of financial information the investing public receives. One industry expert's comment broadly reflects the sentiment of the group:

"Too often, restatements involve both management pressing and exceeding the limits of reasonable accounting interpretations of GAAP and apparent auditor agreement and even participation in the reporting choices that ultimately require restatement."

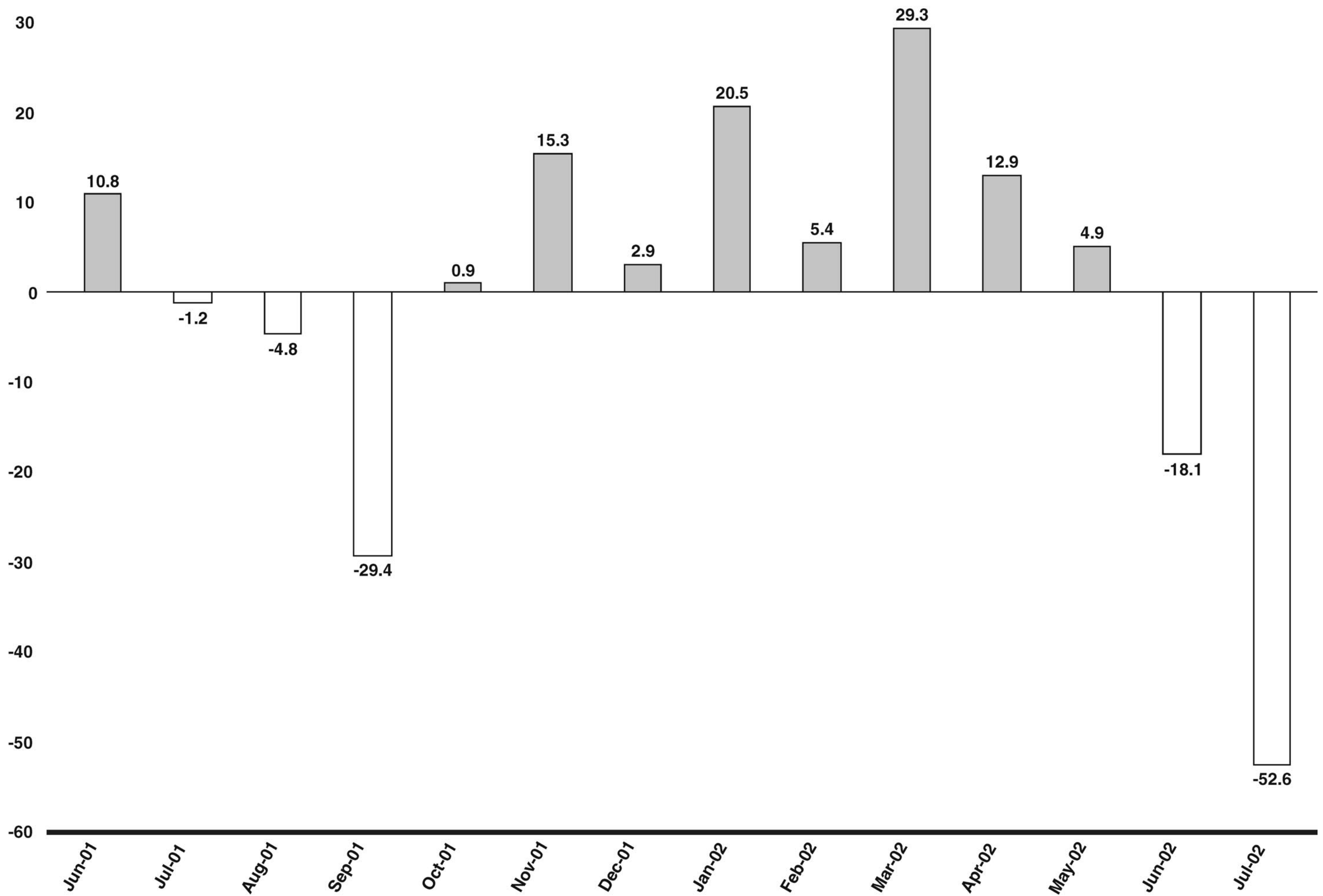
Many of these experts believe that the decline in equity markets and increased market volatility is symptomatic of increased risk and perceived unreliability of financial reports; that is, investor confidence has suffered as a result of the increase in financial statement restatements.

Mutual Fund Flows May Indicate that Investor Confidence Has Been Negatively Affected

Although a variety of factors influence investors' decisions to buy or sell mutual fund shares, mutual fund flow data may indicate that investor confidence has been negatively affected by recent accounting-related irregularities. Implicit in the decision to buy a share of a company's stock is the expectation of future payoffs in the form of dividends, share price increases, or both. Investors' confidence in their ability to accurately value their equity holdings relies upon the accuracy of the information available. If the information provided is not accurate, the reported income stream generated from holding company shares becomes more uncertain and the stock market investment riskier. According to some researchers, mutual fund flows are another indictor of investor sentiment, because mutual funds have become an important alternative to direct purchases of securities. Consequently, this sector has been one of the biggest sources of liquidity in the stock market, reflecting a large number of market participants. Mutual fund investors demonstrate their confidence in the stock market by buying or selling equity mutual fund shares. Annual equity mutual fund net flows (sales less redemptions) declined significantly from 2000 to 2001, falling from $310 billion to $32 billion.[40] Although the monthly mutual fund net flows fluctuated substantially between October 2001 and March 2002, they have exhibited a clear downward trend since March, turning negative in June and July (fig. 8). The outflow of about $18 billion in June 2002 was the fourth-largest outflow ever, and the outflow in July 2002 was the largest outflow on record at the time of our review.

[40]Redemption occurs when a shareholder sells (or redeems) shares back to the mutual fund.

Figure 8: Equity Mutual Fund Net Flows, June 2001–July 2002



Source: Investment Company Institute.

SEC Has Been Investigating an Increasing Number of Cases Involving Accounting-Related Issues

As part of its mission to detect and deter fraud and abuse, SEC's Division of Enforcement (Enforcement) investigates possible violations of securities laws, including those related to accounting issues. Enforcement may recommend action to the Commission when an investigation shows that a violation of the securities laws likely has occurred. However, concerns about staff constraints have raised questions about Enforcement's ability to effectively fulfill its mission. Based on concerns about the quality of financial reporting and accounting abuses, SEC began to focus more attention and investigative activity on accounting-related violations in the late 1990s. From October 1998 to September 2001, almost one in five enforcement cases brought by SEC involved accounting-related issues. To identify the type of enforcement actions brought for accounting-related violations and the parties against whom SEC brought the actions, we analyzed 150 Accounting and Auditing Enforcement Releases (AAER) issued from January 2001 through February 2002.[41]

SEC's Enforcement Function Has Been Challenged Due to Workload and Staffing Issues

Following the recently publicized accounting problems at several large public companies, concerns were raised about the sufficiency of SEC's resources to address ongoing accounting-related issues. As we reported in our March 2002 report on SEC's resources, enforcement was identified as one of the areas most affected by an increasing workload and limited staff resources.[42] We found that SEC's enforcement workload from 1991 to 2000, as measured by opened cases and the number of cases pending at the end of the year, had increased 65 and 77 percent, respectively. Conversely, staff years dedicated to investigations had increased only 16 percent during this same period. Because SEC is unable to pursue every case, SEC officials said that they must prioritize the cases they will pursue. The factors to be considered include the seriousness of the wrongdoing and the message the case would deliver to the industry and public. SEC's enforcement process is often lengthy, with many cases taking years to close.

[41]AAERs are used by SEC staff to catalog accounting-related civil or administrative actions.

[42]GAO-02-302.

SEC Makes Policy Decision to Focus More Attention on Accounting-Related Issues in the Late 1990s

According to SEC documents, SEC views the integrity of financial reporting as a "fundamental building block" of the full and fair disclosure that gives investors confidence in U.S. markets. Moreover, SEC considers pursuit of accounting fraud one of its top enforcement priorities. Since the late 1990s, SEC has focused more attention on accounting-related issues. In a 1998 speech, former SEC Chairman Arthur Levitt raised concerns about earnings management and other accounting and disclosure issues.[43] He stated that:

> "The motivation to meet Wall Street earnings expectations may be overriding common sense business practices. Too many corporate managers, auditors, and analysts are participants in a game of nods and winks. In the zeal to satisfy consensus earnings estimates and project a smooth earnings path, wishful thinking may be winning the day over faithful representation. As a result, I fear that we are witnessing an erosion in the quality of earnings, and therefore, the quality of financial reporting. Managing may be giving way to manipulation; integrity may be losing out to illusion."

In response to these concerns, he articulated a private-public sector action plan that included specific steps. Two of the steps directly required SEC action. One directed SEC staff "to immediately consider interpretive accounting guidance on the do's and don'ts of revenue recognition." Subsequently, SEC's *Staff Accounting Bulletin: No. 101 – Revenue Recognition in Financial Statements* (SAB 101) was issued in December 1999. According to an SEC official, about half of all SEC's accounting-related enforcement cases involved revenue recognition issues. The other step included SEC staff formally targeting reviews of "public companies that announce restructuring liability reserves, major write-offs, or other practices that appear to manage earnings. Likewise, our enforcement team will continue to root out and aggressively act on abuses of the financial reporting process." In September 1999, SEC announced its first coordinated "sweep" of financial reporting violations, which resulted in 30 enforcement actions against 68 individuals and companies for engaging in fraud and related misconduct in accounting, reporting, and the disclosure of financial results by 15 public companies. Individuals cited included chief executive officers (CEO) from 11 of the 15 companies.

[43] Remarks by former Chairman Arthur Levitt, SEC, "The Numbers Game," New York University Center for Law and Business, (New York, N.Y., Sept. 28, 1998).

SEC also leveraged the findings of a March 1999 report by the Committee of Sponsoring Organizations of the Treadway Commission entitled *Fraudulent Financial Reporting, 1987 – 1997: An Analysis of U.S. Public Companies*, which provided an extensive analysis of financial statement fraud occurrences from 1987 to 1997. The report, based on SEC's AAERs, found that over half of financial reporting frauds in the study involved overstating revenue and included information on common characteristics of the companies committing the fraud, such as top management involvement and infrequent audit committee meetings. In May 2000, to further supplement SEC's financial fraud enforcement efforts, SEC created the Financial Fraud Task Force within Enforcement.[44] SEC has reported that the task force continues to focus on the professionals involved in these cases, especially the auditors, who "stand as the watchdogs of the reporting process."

SEC's Enforcement of Accounting-Related Violations Has Increased

Enforcement investigates possible violations of securities laws, including those related to accounting issues, which have increased from about 15 percent in fiscal 1996 to about 20 percent of SEC's total enforcement activity in fiscal year 2001. As figure 9 illustrates, if the evidence gathered merits further inquiry, Enforcement will prompt an informal investigation or request that SEC issue a formal order of investigation. Investigations can lead to SEC-prompted administrative or federal civil court actions. Depending on the type of proceeding, SEC can seek sanctions that include injunctions, civil money penalties, disgorgement,[45] cease-and-desist orders, suspensions of registration, bars from appearing before the Commission, and officer and director bars. After an investigation is completed SEC may institute either type of proceeding against a person or entity that it believes has violated federal securities laws.[46] Because SEC has only civil enforcement authority, it may also refer appropriate cases to the Department of Justice for criminal investigation and prosecution. According to SEC's annual report, most enforcement actions are settled,

[44]The Financial Fraud Task Force consists of a team of accountants and lawyers, who focus exclusively on financial reporting and accounting investigations.

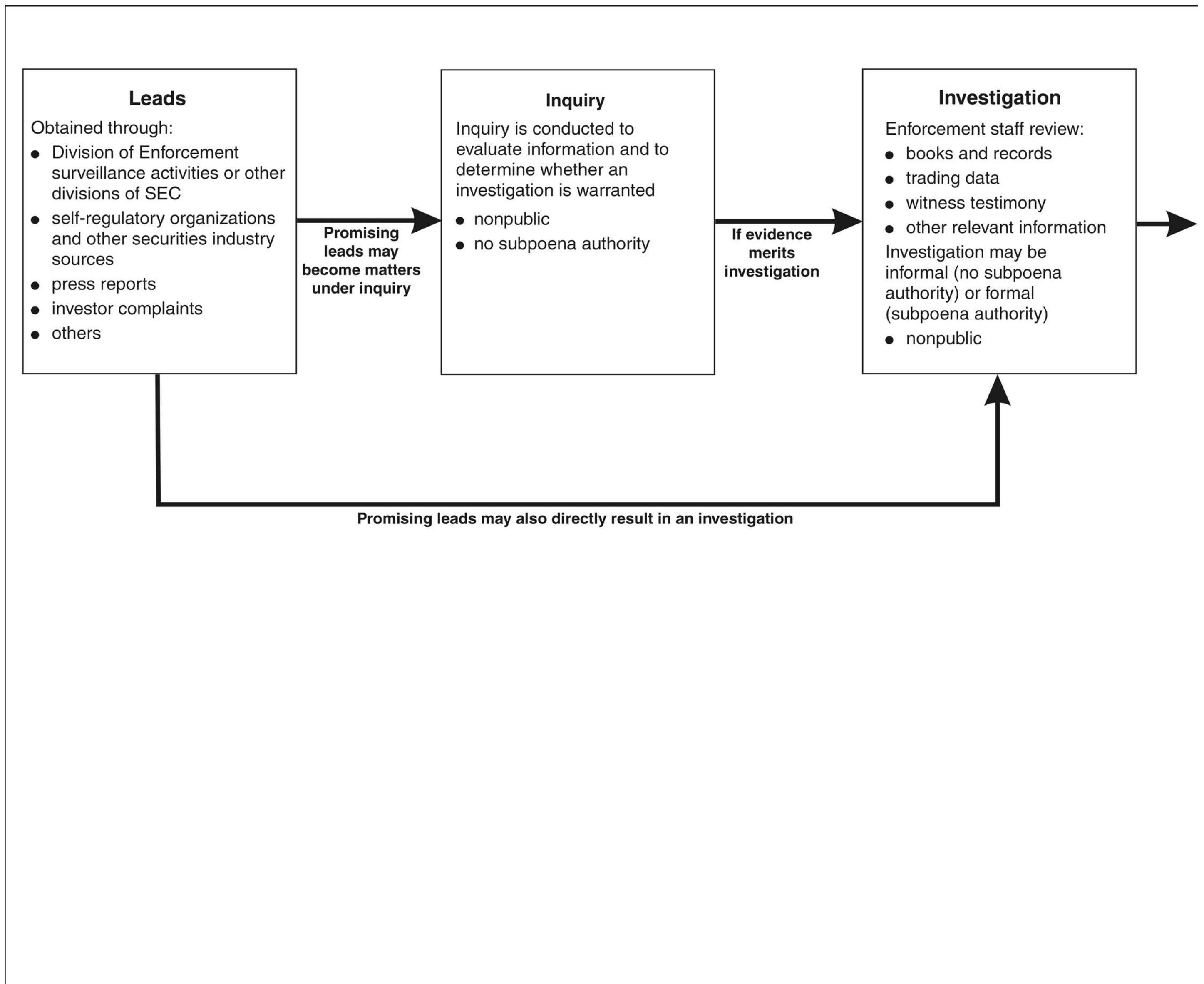
[45]A disgorgement sanction requires the return of illegal profits. See U.S. General Accounting Office, *SEC Enforcement: More Actions Needed to Improve Oversight of Disgorgement Collections*, GAO-02-771 (Washington, D.C.: July 12, 2002) for disgorgement collection information.

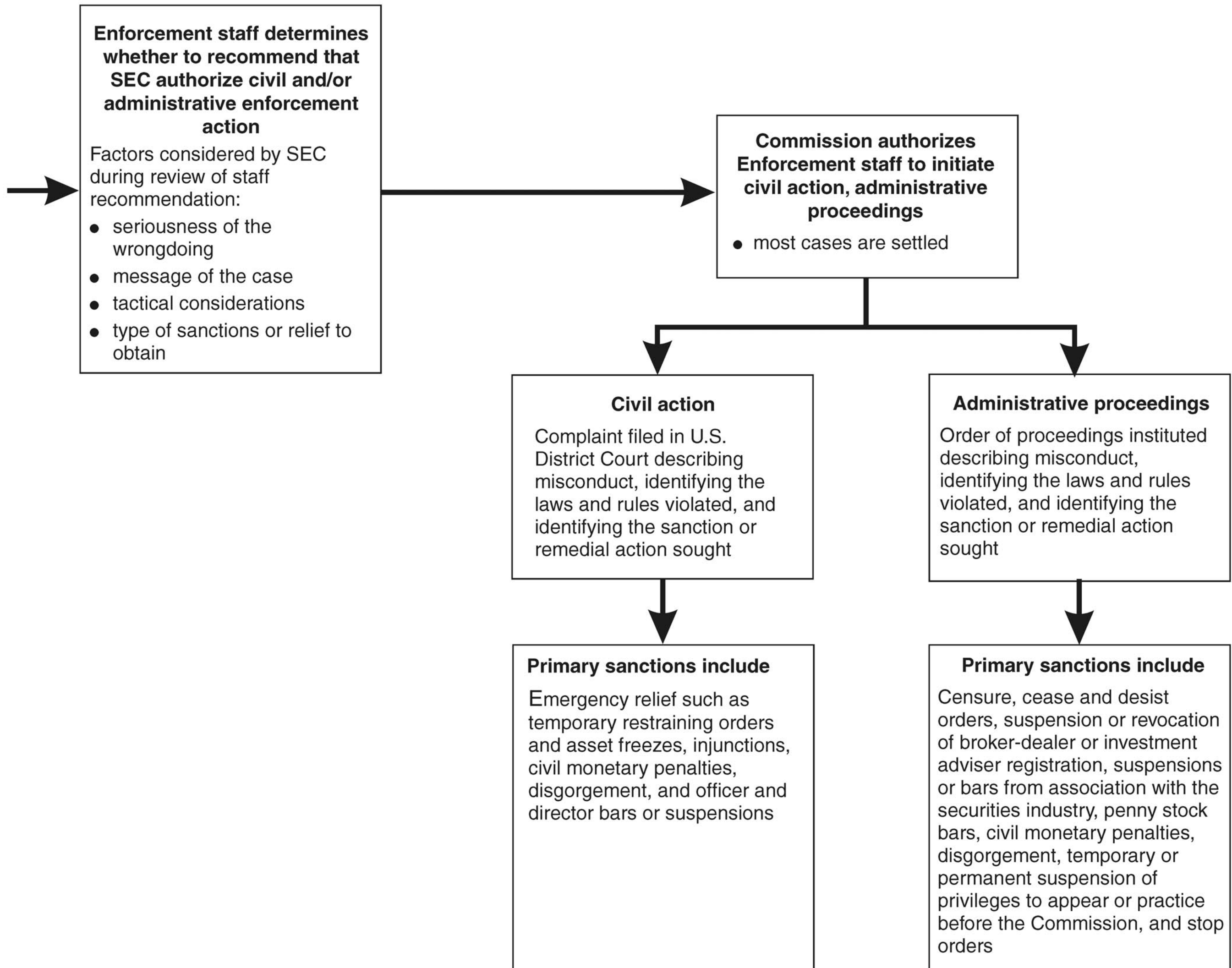
[46]SEC can also initiate contempt proceedings and issue reports of investigation when appropriate.

with respondents generally consenting to the entry of civil judicial or administrative orders without admitting or denying the allegations against them.

In March 2002, SEC announced plans to implement "real-time" enforcement in an effort to take more immediate action to better protect investors. Real-time enforcement is intended to protect investors by (1) obtaining emergency relief in federal court to stop illegal conduct expeditiously; (2) filing enforcement actions more quickly, thereby compelling disclosure of questionable conduct so that the public can make informed investment decisions; and (3) deterring future misconduct through imposing swift and stiff sanctions on those who commit egregious frauds, repeatedly abuse investor trust, or attempt to impede SEC's investigation processes. According to Enforcement officials, real-time enforcement was used recently in its dealings with Adelphia Communications Corporation (Adelphia) and WorldCom, which resulted in the immediate agreement to restate their financial reports. However, according to SEC officials, insufficient resources may inhibit the effectiveness of this initiative, which depends upon prompt action by Enforcement staff.

Figure 9: SEC Enforcement Process



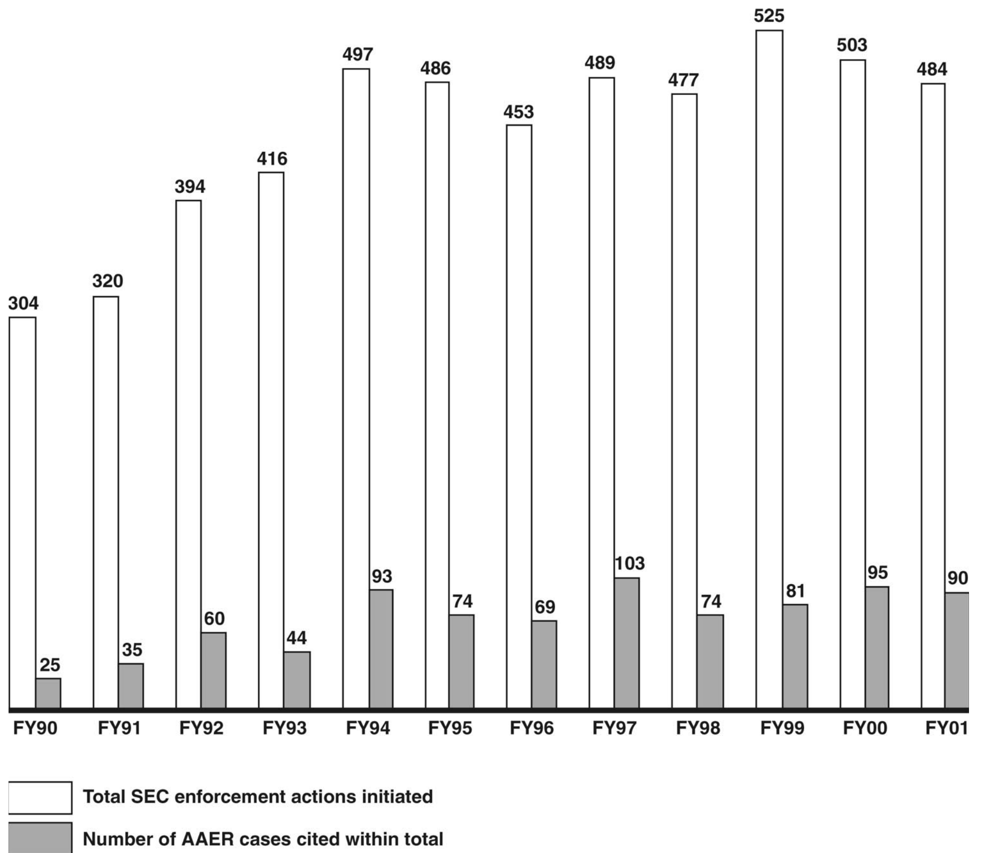


Source: GAO's analysis of SEC's enforcement process.

We found that from fiscal year 1999 through fiscal year 2001, almost 20 percent of all enforcement cases prompted were for accounting-related violations, up from about 8 percent in 1990 (fig. 10). From 1999 to 2001, SEC has brought an average of about 500 total enforcement actions each year. Of these actions, an average of about 89 were accounting-related. To determine the most frequent types of accounting-related violations found in recent SEC enforcement cases, we examined 150 AAERs issued from January 1, 2001, to February 28, 2002.[47] Of the 150 AAERs we reviewed, 87 were administrative, 62 were civil litigation, and one was a report of investigation. The most frequent types of accounting-related violations identified included fraud, filing misleading information with SEC, and failing to maintain proper books and records. Appendix XXII describes some of the most frequently cited violations in greater detail.

[47]Appendix XXI lists the case names of the AAERs we reviewed as well as 78 additional AAERs issued from March through June 2002 that are not included in our analysis.

Figure 10: Number of AAERs and Total SEC Enforcement Actions Initiated, 1990-2001



Notes: Data are for fiscal years. SEC counted some AAERs more than once in total enforcement actions initiated.

Source: GAO's analysis of SEC annual reports.

About 75 percent of the 150 AAERs we reviewed were brought against public companies or their directors, officers, employees, and other parties.[48] The remaining 25 percent involved actions brought against accounting firms and CPAs. SEC officials said that enforcement actions for cases of accounting-related violations are usually brought against the most senior responsible corporate officials. They said that they prefer to charge

[48]See appendixes V through XX for specific examples of enforcement actions taken against selected companies that have announced plans to restate their financial results.

those who had first-hand knowledge of an accounting-related violation. In addition, if an individual knows about an accounting-related violation and does not take corrective action, that person's failure to act may, under some circumstances, be enough to impute liability. Officials also said they usually charge recordkeeping violations directly against the violating public company because the company is responsible for keeping records. SEC may also charge the company with an accounting-related violation when the evidence against a number of individuals is sufficient to presume the behavior is corporate policy at the company. According to one SEC official, historically, SEC has been reluctant to seek civil monetary penalties against companies in financial fraud cases because their costs would be passed along to shareholders who had already suffered as a result of the violations.

Congress, market participants, and others have questioned the lack of severity of many of the sanctions given the level of investor harm. According to one SEC official, because monetary penalties are often paid by officer and director insurance policies or are considered insignificant in relation to the violation, Enforcement should pursue more officer and director bars. However, this official acknowledges that SEC sought more officer and director bars in fiscal year 2001 than in the previous year and the test for imposing officer and director bars is restrictive.[49] We found that of the 150 AAERs we reviewed, SEC charged over 30 chief financial officers (CFO) and over 30 CEOs with accounting-related violations. SEC imposed 23 injunctions; civil monetary penalties totaling over $1.2 million (ranging from $10,000 to $162,000) against 19 individuals; over $2.5 million in disgorgement (ranging from almost $18,000 to over $772, 000) against 10 individuals; 6 cease and desist orders; and 9 officer and director bars.[50] See appendixes V through XX for a summary of the actions taken by SEC in the 16 cases we analyzed.

[49]The Sarbanes-Oxley Act addresses officer and director bars.

[50]Officer and director bars may be issued for a period of time, conditional or unconditional, or they may be permanent.

Enforcement may also bring an enforcement action against other individuals such as officers and principals who are not part of top management (other participants and responsible parties). In the AAERs we reviewed, SEC charged such individuals[51] with accounting-related violations that resulted in 31 injunctions, over $1.8 million in civil monetary penalties (ranging from over $8,000 to $350,000) against 29 individuals; over $1 million in disgorgement (ranging from $10,000 to over $521,000) against 13 individuals; 21 cease and desist orders; and 9 officer and director bars. For example, SEC and in some cases the Department of Justice have filed suit against several former senior officers at public companies, including Waste Management Inc. (Waste Management), Rite Aid Corporation (Rite Aid), Critical Path, and Adelphia.[52] These former executives have been charged with securities law violations such as fraud, fraudulent reporting, record-keeping violations, and insider trading. Further, they have been accused of forging contracts, purchase orders, and other documents, lying to auditors, and entering into undisclosed agreements to falsely boost a company's revenue.

[51]Excludes CEOs, CFOs, and CPAs.

[52]For a detailed discussion of SEC's actions against Adelphia, Critical Path, Rite Aid, and Waste Management, see appendixes V, VII, XIII, and XIX, respectively.

Enforcement may also bring actions against accounting firms when the facts indicate that the controlling principals of an accounting firm committed an accounting or other violation. If the accounting firm is one of the U.S. “Big Five,” the accounting issues must rise to the “national level” before SEC will take action against the entire firm.[53] SEC officials characterized a national-level issue as one in which one or more principals at the national office of the firm are culpable in connection with the wrongful conduct, regardless of whether they are on the engagement team. Enforcement also investigates improper professional conduct by accountants and other professionals who appear before SEC, and the agency may pursue administrative disciplinary proceedings against these professionals under SEC’s Rules of Practice 102(e).[54] If SEC finds that securities laws have been violated or improper professional conduct has occurred, it can prohibit professionals from appearing before SEC temporarily or permanently. Enforcement officials told us that SEC typically pursues cases in which a licensed accountant or auditor violates the securities laws or demonstrates improper professional conduct under Rule 102(e). A licensed accountant engages in improper professional conduct if he or she intentionally or knowingly violates an applicable professional standard or engages in either of the two types of negligent conduct defined under the rule.[55] As table 6 shows, from January 2001 through February 2002, SEC has taken action against 39 CPAs, 1 accountant, and 9 accounting firms. In addition, SEC has imposed 14 injunctions, over $7.7 million in civil monetary penalties (ranging from

[53]As of May 2002, the “Big Five” accounting firms were KPMG LLP, Arthur Andersen LLP (Arthur Andersen), Ernst & Young LLP, PricewaterhouseCoopers LLP, and Deloitte & Touche LLP. On June 15, 2002, Arthur Andersen was convicted on one felony count of obstruction of justice. Although Arthur Andersen planned to appeal the conviction, the firm notified SEC it planned to cease practicing before the Commission by August 31, 2002. If the appeal fails, the conviction would be grounds for automatic suspension of the firm’s ability to practice before SEC, leaving only the “Big Four” accounting firms. See 17 C.F.R. § 201.102(e)(2002). On September 2, 2002, Arthur Andersen announced that it surrendered to state regulators all licenses “to practice public accountancy.”

[54]Rule 102(e), 17 C.F.R. § 201.102(e)(2002), authorizes SEC to take action against those who do not have requisite qualifications, engage in unethical or improper professional conduct, or willfully violate or aid and abet violations of the securities laws. Pursuant to the rule SEC may temporarily or permanently deny an individual the privilege of appearing or practicing before SEC.

[55]Rule 102(e)(2) also provides that any licensed professional whose license to practice has been revoked or suspended in any state or who has been convicted of a felony or misdemeanor involving moral turpitude shall be suspended from appearing or practicing before SEC.

$30,000 to $7 million) against 8 individuals and firms; over $83,000 in disgorgements (ranging from over $16,000 to almost $42,000) against 2 individuals and 1 firm; and issued 33 cease and desist orders.

Table 6: Rule 102(e) and Cease and Desist Actions Against CPAs and Accounting Firms, January 2001-February 2002

Action	Number of CPAs	Number of (non-CPA) accountants	Number of (non-Big Five) accounting firms	Number of Big Five accounting firms
Suspended or denied the privilege of appearing or practicing before the SEC for:				
1 year	4	0	0	0
2 years	3	0	0	0
3 years	16[a]	0	2	0
5 years	2	0	0	0
10 years	1	0	0	0
Unspecified	2	1	1	0
Permanent	4	0	1	0
Cease and desist	6	0	1	1
Censure	1	0	0	3
Total actions	**39**	**1**	**5**	**4**

[a]Of the 16, 14 were currently CPAs and 2 were former CPAs.

Note: In two cases, CPAs received suspensions for an unspecified period, and then received permanent suspensions. CPAs and accounting firms who receive suspensions may apply for reinstatement of privileges after the stated time has elapsed.

Source: GAO's analysis of SEC AAERs issued from January 2001 through February 2002.

SEC may also charge outside auditors with fraud in certain cases. For example:

- If an outside auditor finds an accounting violation or misrepresentation while conducting an audit but does not take action to correct the matter, the auditor has failed to comply with GAAS, and issues a materially misleading report.

- If a fraud occurred that an outside auditor found out about and the auditor failed to take appropriate action, the auditor has failed to comply with GAAS and Section 10A of the Exchange Act, thus contributing to a material misstatement (a GAAP violation).[56]

- If there is evidence to prove that an outside auditor also functioned as an adviser with regard to financial reporting that violates SEC reporting requirements, the auditor has violated GAAS independence rules.

SEC has brought a number of recent actions against accounting firms for accounting-related violations. For example, in 2001, SEC obtained the first antifraud injunction in more than 20 years against one of the "Big Five" accounting firms. While neither admitting nor denying the charges, Arthur Andersen agreed to pay $7 million to settle charges that it allegedly "knowingly or recklessly issued materially false and misleading audit reports on Waste Management's financial statements." SEC found that the Waste Management financial statements that Arthur Andersen audited from 1992 to 1996 had overstated pretax income by more than $1 billion. In another case, SEC brought a fraud action against an Arthur Andersen partner for authorizing unqualified audit opinions on Sunbeam Corporation's 1996 and 1997 financial statements. In January 2002, SEC censured KPMG LLP for engaging in improper conduct because it served as an independent accounting firm for an audit client while making substantial investments in the company. Most recently, while neither admitting or denying the charges, in July 2002 PricewaterhouseCoopers LLP settled SEC charges that it violated auditor independence rules. Although SEC retains its current authority under Sarbanes-Oxley for enforcing securities laws, this is an area that is likely to evolve as the new Board begins to carry out its new duties to sanction accounting firms and accountants that violate accounting and auditing standards.

[56]Under Section 10A of the Exchange Act, 15 U.S.C. § 78j-1(2000), an auditor who becomes aware that an illegal act occurred or may have occurred must take certain actions, which include informing the appropriate level of the company's management and directors and, if the company fails to take adequate remedial action, the auditor may resign from the engagement and must furnish pertinent information to the Commission.

The Growing Number of Accounting Problems in the Corporate Financial Reporting System Have Spurred Reforms

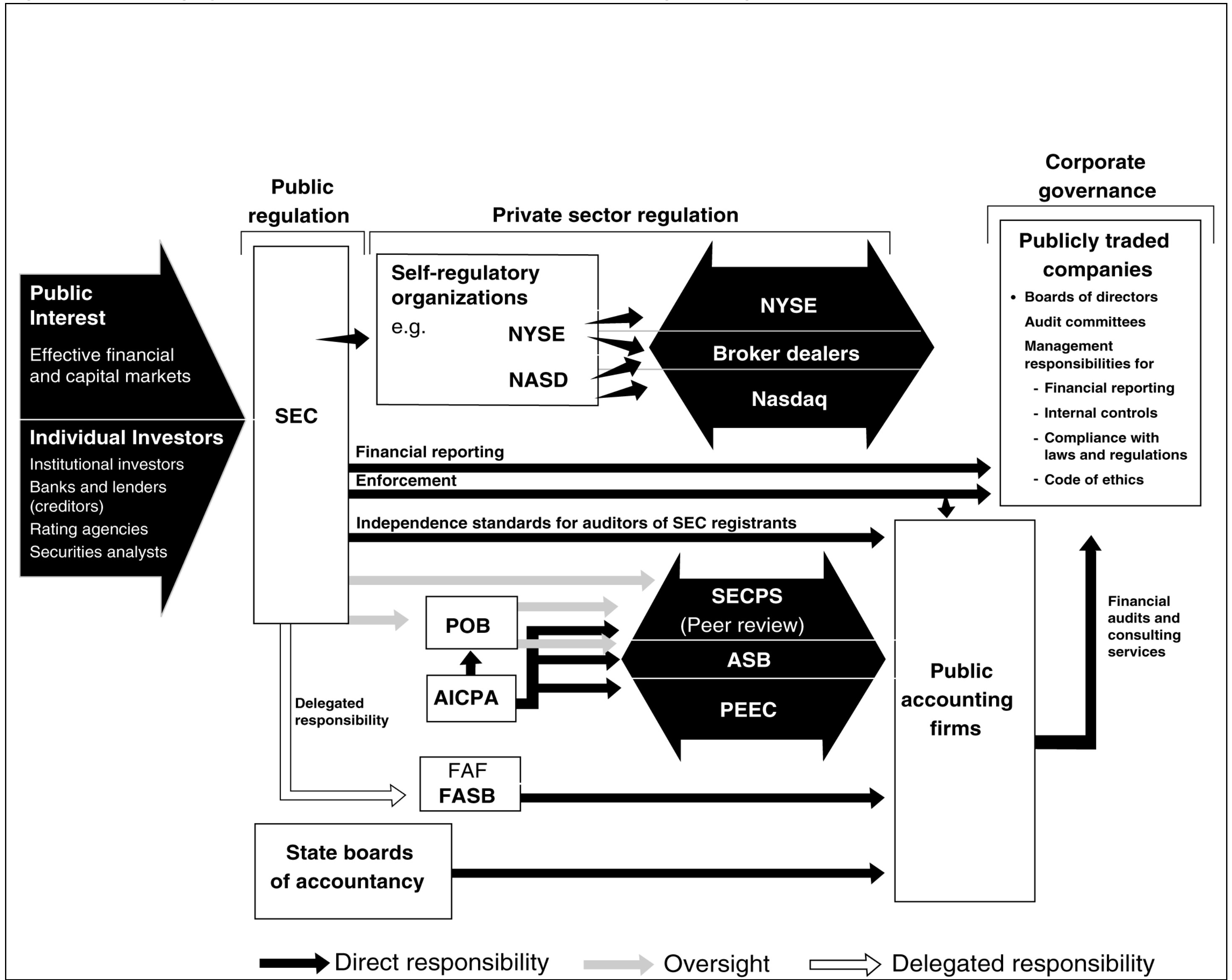
The growing number of accounting problems, particularly among large public companies, illustrates weaknesses in the current corporate governance and financial reporting system at virtually every level. In a number of the restating companies we identified, corporate management, boards of directors, and auditors failed in their roles, as have the securities analysts and credit rating agencies that did not identify problems before investors and creditors lost billions of dollars. As we have previously reported and testified, current corporate governance and accounting oversight structures have limitations and need to be improved.[57] In an effort to restore investor confidence, Congress passed and the President signed legislation that requires major changes in the regulation of the accounting profession and corporate governance. The Sarbanes-Oxley Act focuses on many of the needed changes, including increasing corporate executive accountability, creating a new auditor oversight body, increasing SEC's resources, and addressing stock analysts' conflicts of interest. Likewise, SEC and others have also taken actions or proposed action to address some of these issues. Although the legislation authorized additional funding for SEC, it continues to face challenges in addressing its traditional and new more expansive roles.

Corporate Governance, Auditing Oversight Systems, and Financial Reporting All Have Come Under Scrutiny

As the number of financial statement restatements resulting from accounting irregularities has increased, the existing fragmented corporate governance and accounting oversight structures have been called into question (fig. 11). First, questions have been raised about the adequacy of the current system of corporate governance (including corporate management, boards of directors, audit committees, and auditors) and its ability to protect investors and ensure the integrity of public disclosures, as evidenced by recent accounting issues and corporate failures. Second, the effectiveness of independent auditors, who are supposed to provide an additional level of verification for the financial information disclosed to the public, has also been scrutinized due to failures to perform impartial and unbiased audits to ensure that financial data are fairly represented in a number of cases. Third, the sudden unexpected collapse of large public companies like Enron and WorldCom has raised questions about the role played by market participants such as securities exchanges, securities analysts, and credit rating agencies.

[57] GAO-02-742R, GAO-02-483T, and GAO-02-601T.

Figure 11: Existing System of Corporate Governance and Accounting Oversight Structures



Notes: Existing structure, prior to the implementation of Sarbanes-Oxley Act of 2002. Also, the Public Oversight Board (POB) dissolved itself, effective May 1, 2002.

Source: GAO analysis.

Weaknesses in Corporate Governance and Financial Reporting Have Resulted in Problems at Several Large Companies

Executives and boards of public corporations have an important, difficult, and challenging responsibility to protect the interests of shareholders, because corporations must address issues such as globalization and rapidly evolving technologies and at the same time maintain or raise market values by meeting quarterly earnings projections. These pressures, combined with executive compensation arrangements, often translate into a focus on short-term business results. This situation can create perverse incentives to "manage" earnings to report favorable financial results, and to disguise risks, uncertainties, and commitments by failing to provide transparency in financial reporting. In certain cases, audit committees have not effectively helped to protect shareholder interests and at times, failed to provide sound leadership and oversight of the financial reporting process.

Likewise, as we reported in 1996, the financial reporting model, also critical in promoting an effective allocation of capital among companies, does not fully meet users' needs for transparency.[58] The existing reporting model is not well suited to identifying and reporting on key value and risk elements inherent in our twenty-first century knowledge-based economy. We found that despite the continuing efforts of the Financial Accounting Standards Board (FASB) and SEC to enhance financial reporting, changes in the business environment—such as the growth in information technology, new types of relationships between companies, and the increasing use of complex business transactions and financial instruments—constantly threaten the relevance of financial statements and pose a formidable challenge for standard setters. A basic limitation of the model is that financial statements present the business entity's financial position and results of its operations largely on the basis of historical costs, which do not fully meet the broad range of user needs for financial information.[59] Enron's failure and the inquiries that have followed again have raised many questions about the adequacy of the current financial reporting model, such as the need for additional transparency, clarity, more timely information, and risk-oriented financial reporting.

[58] GAO/AIMD-96-98.

[59] The accounting and reporting model under GAAP is actually a mixed-attribute model. Although most transactions and balances are measured on the basis of historical cost, which is the amount of cash or its equivalent originally paid to acquire an asset, certain assets and liabilities are reported at current values either in the financial statements or related notes. For example, certain investments in debt and equity securities are currently reported at fair value, receivables are reported at net realizable value, and inventories are reported at the lower of cost or market value. Further, certain industries such as brokerage houses and mutual funds prepare financial statements on a fair-value basis.

In addition, as we reported earlier this year, boards of directors and their audit committees are a critical link to fair and reliable financial reporting.[60] However, recent actions or inaction by boards of directors (especially audit committees) of several public companies have raised questions about how well this system of oversight functions. For example, the *Report of Investigation by the Special Investigation Committee of the Enron Board of Directors* (known as the Powers Report) identified several failures of the board in overseeing Enron's relationships with several special purpose entities.[61] The report found that while Enron's board put certain controls in place, many of the controls were not adequate nor were they properly implemented. Moreover, the report also found that while the board did not receive certain information, it also failed to appreciate important information that was brought to its attention. Finally, the report found that the audit committee had a responsibility to review related-party transactions but performed only a cursory review. More generally, Congress, experts, and others have raised questions about the independence of corporate boards and the effectiveness of the independent director function in protecting shareholders.

Allegations of Accounting Fraud Raise Questions about the Quality of Audits

Auditors are responsible for planning and performing audits to obtain reasonable, but not absolute, assurance that financial statements are free from direct and material misstatement, whether caused by error or fraud. However, Congress and others have questioned the effectiveness of the voluntary, self-regulatory system maintained through the American Institute of Certified Public Accountants (AICPA) because it lacks a meaningful oversight structure or substantive penalties.[62] Likewise, some critics of the accounting profession's peer review system, which was established to monitor member public accounting firms for compliance with standards, viewed the system as largely ineffective (fig. 11). Although SEC has the statutory authority to establish accounting standards and issues interpretative guidance and staff accounting bulletins on accounting and auditing matters, SEC has delegated much of its responsibility for setting standards for financial reporting and independent audits to the private sector. It has accepted accounting standards (GAAP) established by

[60]GAO-02-483T.

[61]Special purpose entity is a business entity created solely to carry out a special purpose, activity, or series of transactions directly related to its special purpose.

[62]AICPA establishes professional standards, monitors compliance with professional standards, and disciplines members for improper acts and substandard performance.

FASB as the primary standards for preparation of financial statements. Similarly, SEC has accepted the auditing standards, GAAS, promulgated by the Auditing Standards Board (ASB) as the standards for independent audits.

As stated over the years by many who have studied the accounting profession, no major aspect of the independent auditor's role has caused more difficulty than the auditor's responsibility for detecting fraud. As we testified earlier this year, in August 2000, the Panel on Audit Effectiveness concluded that the auditing profession needed to address vigorously the issue of fraudulent financial reporting, including fraud in the form of improper earnings management.[63] The report expressed concern that auditors may not be requiring enough evidence—that is, they have reduced the scope of their audits and the level of testing below what is needed to reasonably ensure the reliability of the financial information upon which they report. Some academics have questioned the profession's movement toward audits that focus on business processes and the information systems used to generate financial information. Likewise, others question the AICPA's proposed audit processes, which make many of the audit steps aimed at detecting a material misstatement caused by fraud optional instead of mandatory.

The increase in financial statement restatements involving accounting irregularities has caused questions about the independence and quality of audits being conducted by the independent auditors to resurface.[64] As we testified, the current fragmented corporate governance and oversight structure and lack of a strong self-disciplinary mechanism as a contributing factor. Likewise, since the mid-1970s, many observers of the auditing profession have expressed concerns about expanding the scope of professional services provided by the public accounting profession. One common concern is that auditors' fees for consulting services, which are a substantial part of the total fees, can create actual or perceived conflicts that threaten auditors' independence. The independence of public accountants—both in fact and in appearance—is crucial to the credibility

[63]*The Panel on Audit Effectiveness Report and Recommendations*, August 31, 2000.

[64]Although additional analysis such as who the independent auditors were and their role in prompting the restatement for the 919 restatements identified was beyond the scope of this review, we included this type of analysis in our 16 case studies (app. V through XX). We plan to include a more comprehensive analysis of this issue in our work on mandatory audit rotations as required by the Sarbanes-Oxley Act.

of financial reporting and, in turn, the capital formation process.[65] While this issue has been studied and debated for years, the Enron failure has brought the issue to the forefront once again because of the close relationship between Arthur Andersen and Enron. As mentioned previously, two recent cases, although not related to restatements, addressed this growing concern. First, SEC censured KPMG LLP in January 2002 for engaging in improper professional conduct because it served as an independent accounting firm for an audit client while making substantial investments in money market portfolios operated by the client.[66] Second, in July 2002, while neither admitting nor denying the charges, PricewaterhouseCoopers LLP settled SEC charges that it violated auditor independence rules.

Recent Accounting Cases Have Raised Questions About Other Players as Well

Stock exchanges or markets, credit rating agencies, and securities analysts also have roles in the corporate governance or corporate financial reporting process.[67] Listing standards provide investors with some degree of assurance that the public companies listed on national stock exchanges and markets generally meet certain minimum standards of operation. Listing standards address several quantitative requirements such as operating history, income, and share price. They also include specific guidelines on corporate governance. Although public companies that fail to meet listing standards can be delisted, not all companies that fail to comply with the guidelines are delisted. For example, we reported in our 2001 report on Amex listing standards, in the first 8 months of 2000, one-third of Amex's new listings did not meet the exchange's listing standards.[68]

[65]Auditor independence standards require that the audit organization and auditor be independent in fact and in appearance.

[66]KPMG LLP was the independent auditor for AIM Funds, a family of mutual funds managed by AIM Management Group, Inc., which offers different funds and portfolios including Short-Term Investments Trust, a money market fund in which KPMG LLP had an investment. KPMG LLP neither admitted nor denied the charges.

[67]To determine the information being provided by securities analysts and credit rating agencies before and after several restatement announcements, we conducted 16 case studies of public companies that have restated or announced the need to restate their financial results.

[68]In U.S. General Accounting Office, *Securities Regulation: Improvements Needed in the Amex Listing Program*, GAO-02-771 (Washington, D.C.: July 12, 2002), we reviewed Amex's compliance with its listing standards, which they refer to as guidelines.

Recent questions about the quality of financial disclosure have resulted in criticism of the role played by credit rating agencies and securities analysts in promoting investment in many now-bankrupt companies or failing to downgrade ratings before problems occurred, such as at Enron and WorldCom. Credit rating agencies have been criticized as reactive and unable to identify potential problems. Likewise, one of the primary flaws cited in the existing analyst structure is the potential for conflicts of interest. For example, providing investment-banking services, such as underwriting an IPO or advising on a merger or acquisition, can be a lucrative source of revenue for an analyst's firm. As a result, analysts may face pressure not to say or write things that could jeopardize existing or potential client relationships for their investment banking colleagues.

Moreover, brokerage firms' compensation arrangements can put pressure on analysts to issue positive research reports and recommendations. Many analysts are paid at least partly and indirectly on the basis of their firms' underwriting profits. Therefore, they may be reluctant to make recommendations that could reduce such profits and, hence, their own compensation. Recently securities analysts have been investigated for recommending stocks of companies to help investment-banking colleagues win lucrative underwriting contracts, even though e-mail messages from analysts indicated that privately the analysts did not support their public ratings. Most notably, the New York State Attorney General investigated Merrill Lynch & Company, Inc.'s research practices, which resulted in the firm paying a $100 million fine in May 2002. In addition, other regulators and prosecutors launched inquiries into analyst research. In September 2002, NASD fined Salomon Smith Barney (Salomon) $5 million for issuing materially misleading research in 2001 on Winstar Communications, Inc. (Winstar).[69] Separately, NASD announced that it filed a complaint against the former managing director of Salomon's Equity Research Department and a Salomon vice president. NASD alleged that the two worked closely with Winstar's management and consulted management prior to issuing research reports that reportedly reflected their independent judgment and analysis. NASD also found that Salomon's reports failed to adequately disclose the risks of investing in Winstar, including important risks relating to funding and bankruptcy. The complaint also charged that while publicly

[69]According to NASD's news release, the September 23, 2002, settlement between NASD and Salomon resolves the NASD investigation into Salomon's Winstar reports and does not address other, larger Salomon-related research analyst investigations currently under way by NASD and other regulators.

recommending Winstar to investors, they expressed contrary views in private.

Recent Legislation, Other Actions, and Ongoing Initiatives Address Major Aspects of Oversight

To address many of the limitations of and lapses in the existing structure, Congress, SEC, and others have taken a variety of actions. The Sarbanes-Oxley Act was enacted on July 30, 2002, to overhaul the existing corporate governance and accounting oversight structure by increasing corporate executive accountability, creating a new auditor oversight body, significantly increasing SEC's budget, and addressing other issues such as securities analysts' conflicts of interest. SEC has also taken a number of steps aimed at strengthening its review function, corporate accountability, and enforcement program. Likewise, the SROs have strengthened rules that address certain conflict-of-interest issues and have proposed listing standards that address corporate governance.

New Law Addresses Regulation of Accounting and Corporate Governance

The Sarbanes-Oxley Act addresses many of the concerns about corporate reporting by enhancing the oversight of financial accounting. The act creates a new oversight body, the Public Company Accounting Oversight Board, to oversee audits of public companies. The act requires that any public accounting firm that performs any audit report for any publicly held company register with the Board. To ensure the independence of this new Board, it will be structured as a nonprofit corporation funded by registration and annual fees from registered public accounting firms and support fees assessed to issuers. A majority of its members will be nonaccountants. Unlike the previous oversight structure (that is, the defunct Public Oversight Board), this new board will have sweeping powers to inspect accounting firms, set rules and standards for auditing, and impose meaningful sanctions on violators. Furthermore, the act addresses auditor independence issues, among other things, by prohibiting auditors from providing certain nonaudit services to their audit clients and strengthening the oversight role of the board of directors. To increase corporate accountability, corporate boards of directors' audit committee members must be "independent" and are responsible for selecting and overseeing independent auditors. In addition, pursuant to SEC rules required by the act, top corporate officials will have to personally attest to the accuracy of their firm's accounting (and can face civil and criminal penalties if the certifications are false). The act also addresses numerous other issues aimed at strengthening investor confidence, including requiring that the SROs and SEC implement rules to address analysts' conflicts of interest, increasing criminal sanctions, and requiring that SEC issue rules that address standards of professional conduct for attorneys.

(See app. XXIII, for a detailed side-by-side comparison of the Sarbanes-Oxley Act and the existing governance and accounting oversight structure.)

SEC and Others Have Taken Steps to Address Concerns about the Existing Oversight Structure

Because staffing levels were expected to remain flat while filings increased in number and complexity, in 2001 SEC began reconsidering how it approaches selecting filings for review and how to review those filings. As part of this effort, SEC began reviewing its existing screening criteria to make better use of its resources and target the areas of highest risk. The plan includes limiting reviews to specific disclosure issues or areas of material importance and assigning reviews to experienced staff. Following the sudden collapse of Enron, in late December 2001, SEC announced that CorpFin would review the annual reports filed by all Fortune 500 companies in 2002 as part of its process of reviewing disclosures—financial and nonfinancial—by public companies. According to SEC, CorpFin is to focus on disclosures that appear to be critical to an understanding of each company's financial position and results but that also appear to conflict significantly with GAAP or SEC rules and guidance or to be materially deficient in explanation or clarity.

According a CorpFin official, the division staff are looking at qualitative disclosure as a general matter and, in light of recent events, putting a strong emphasis on companies' financial statements and the "management discussion and analysis" portion of annual reports. He added that in an initial review of the Fortune 100 companies, SEC sent a "small number" of letters to issuers, expressing concerns about their reports. The subsequent separate review of the Fortune 500 companies identified more widespread problems. In June 2002, CorpFin announced that it had completed screening the annual reports of most of the Fortune 500 companies and had selected a "very significant number" for a more detailed review. Moreover, staff had issued letters to certain companies and had started to receive responses. According to a CorpFin official, as of June 17, 2002, the staff had not referred any matter arising from the review to Enforcement for further inquiry that was not already the subject of Enforcement interest or activity.[70]

On June 27, 2002, in light of reports of accounting irregularities at publicly traded companies, including some large and seemingly well-regarded companies, SEC announced that it had initiated an investigation to obtain

[70]When it appears that securities laws have been violated, CorpFin may refer matters to Enforcement.

information about conditions, practices, and other matters relating to the financial statements and accounting practices of some large publicly traded companies. The purpose of the Commission's investigation is to provide greater assurance to SEC and investors that "persons have not violated, or are not currently violating, the provisions of the federal securities laws governing corporate issuers' financial reporting and accounting practices." As part of this investigation, the Commission required written statements, under oath, from senior officers of 947 publicly traded companies (which had over $1.2 billion in revenue in their last fiscal year). The order required that the principal executive officer and principal financial officer of each company shall:

"either (a) file a statement in writing, under oath, in the form of the "Statement Under Oath of Principal Executive Officer and Principal Financial Officer Regarding Facts and Circumstances Relating to Exchange Act Filings," or (b) file a statement in writing, under oath, describing the facts and circumstances that would make such a statement incorrect. In either case, such statement shall further declare in writing, under oath, whether or not the contents of the statement have been reviewed with the company's audit committee, or in the absence of an audit committee, the independent members of the company's board of directors."

As of September 20, 2002, SEC's Web site posted that 841 companies had filed certifications, 13 companies indicated that their officers could not file such an oath, and the remaining oaths are due between September 2002 and December 2002, depending on when the company's fiscal year ends.[71]

On May 10, 2002, SEC approved NYSE and NASD rules that address issues involving analysts' conflicts of interest (table 7).[72] However, these rules only enhance the scope of the SROs' authority over analysts employed by their members; due to jurisdictional limitations, the rules do not apply to analysts employed at credit rating agencies or analysts who are not employed by member broker-dealers. SEC announced in July 2002 that it also plans to propose rules to address conflicts of interest among securities analysts.

[71]The 13 companies whose CEOs and CFOs did not file the oath were (1) ACT Manufacturing, Inc.; (2) Adelphia; (3) CMS Energy Corp.; (4) Consolidated Freightways; (5) Dynegy, Inc.; (6) Enron; (7) Gemstar-TV Guide International, Inc.; (8) IT Group, Inc.; (9) The LTV Corporation; (10) McLeodUSA Incorporated; (11) Qwest Communications Int'l, Inc.; (12) TruServ Corporation; and (13) WorldCom.

[72]The SROs are to implement the specific reforms on a staggered schedule, ranging from 60 days to 180 days from approval.

Table 7: NYSE Rules 472 and 351 and NASD Rule 2711 Changes Affecting Securities Analysts

Activity	Rule change
Limitations on Relationships and Communications	• research analysts cannot be supervised or controlled by the investment banking department • investment banking personnel are prohibited from reviewing or approving analyst research reports prior to publication except to verify factual accuracy and detect potential conflicts of interest • prepublication communications between investment banking personnel and research department personnel must be conducted through or monitored by a legal or compliance official • analysts are prohibited from sharing research reports with subject companies prior to publication except for verification of factual accuracy, provided that drafts do not contain the research summary, research rating, or the price target, and that legal or compliance officials are involved
Limitations and Disclosures Regarding Analyst and Firm Compensation	• securities firms are barred from tying an analyst's compensation to specific investment banking transactions • if the principally responsible analyst's compensation is based on the firm's general investment banking revenues, that fact must be disclosed in the firm's research reports • a securities firm must disclose in a research report if, in the past 12 months, it managed or comanaged a public offering of equity securities for the subject company or received any compensation for investment banking services from the company and if, in the next 3 months, it expects to receive or intends to seek compensation for investment banking services from the subject company
Promises of Favorable Research and Quiet Period	• securities firms are prohibited from offering favorable research, a specific rating, or a specific price target and from threatening to change research, a rating, or a specific price target to induce investment banking business • "quiet periods" – with certain exceptions and conditions, firms that have acted as a manager or comanager of a subject company's securities offering are barred from issuing a report on the company within 40 days after an initial public offering or within 10 days after a secondary offering
Restrictions on Personal Trading by Analysts	• analysts and members of their households are barred from investing in a company's securities prior to its initial public offering if the company is principally engaged in the business sector that the analyst covers • "blackout periods" – generally prohibits analysts and members of their households from trading securities of the companies they follow for 30 days before and 5 days after they issue a research report about the company or a change in a rating or price target of the company's securities • analysts are prohibited from trading securities and related derivatives in a manner inconsistent with the analyst's most recent recommendations
Analyst and Firm Disclosures Regarding Ownership of Securities	• analysts are required to disclose in public appearances, and a firm must disclose in research reports, if the analyst or a member of his or her household has a financial interest in the securities of a recommended company and the nature of the financial interest • analysts are required to disclose in public appearances, and a firm must disclose in research reports, if the firm owns 1 percent or more of any equity class of a recommended company as of the previous month end • analysts and firms must similarly disclose (1) if the analyst or a member of the analyst's household serves as an officer, director, or advisory board member of the subject company and must disclose (2) any other material conflicts of interest the analyst knows or has reason to know about • analysts must disclose in public appearances if the analyst knows or has reason to know that the subject company is a client of the firm or its affiliates

(Continued From Previous Page)

Activity	Rule change
Disclosures in Research Reports Regarding the Firm's Ratings and Other Matters	• firms must define in research reports the meaning of all ratings used in the ratings system and the definition of each rating must be consistent with its plain meaning • firms are required to provide in research reports information about the distribution of the firm's ratings, including the percentage of all securities rated by the firm to which the firm would assign a "buy," "hold/neutral," or "sell" rating, and the percentage of companies within each category for whom the firm provided investment banking services within the previous 12 months • for a securities firm that has rated for at least 1 year, firms are required to provide in research reports a graph or chart that plots historical price movements of the security and indicate those points at which the firm assigned or changed ratings and price targets for the company • firms must disclose in research reports (1) the valuation methods used to determine a price target and a discussion about the risks that may impede achievement of the price target and (2) whether the firm was making a market in the subject company's securities at the time the research report was published

Sources: NASD Rule 2711, SEC Release No. 34-45908, and SEC Press Release 2002-63.

In 2002, Nasdaq and NYSE also announced plans to strengthen corporate governance through new listing standards.[73] In May and July 2002, Nasdaq announced that its board of directors had approved modifications to several of its corporate governance standards. Both NYSE and Nasdaq have proposed similar changes.[74] According to Nasdaq officials, it is in the process of harmonizing its proposed listing standards with the provisions set forth in the Sarbanes-Oxley Act. Nasdaq's planned rule changes include the following:

- tightening the definition of an independent director;
- requiring corporate boards to have a majority of independent directors;
- requiring regular meetings of independent directors in executive session;
- strengthening the role of independent directors in compensation and nomination decisions;
- requiring corporate codes of conduct;

[73]On September 13, 2002, Amex announced that its board had approved a proposal to enhance its corporate governance rules, which Amex planned to submit to SEC for its review and approval. GAO is in the process of reviewing various aspects of Amex, Nasdaq, and NYSE's listing programs, including the recent changes to their corporate governance standards.

[74]Both proposals include certain exemptions for companies with a controlling shareholder.

- mandating continuing director education;
- requiring that related-party transactions be approved by an issuer's audit committee or comparable body;
- clarifying that a company can be delisted for misrepresenting information to Nasdaq;
- requiring that companies disclose the receipt of an audit opinion with a going concern qualification;
- requiring shareholder approval for stock option plans and changes;
- permitting companies to disseminate material information via Regulation FD (Fair Disclosure)–compliant methods of disclosure, instead of solely by a press release;[75]
- prohibiting loans to officers and directors consistent with the Sarbanes-Oxley Act; and
- requiring that non-U.S. issuers disclose any exemptions to corporate governance requirements.

On August 1, 2002, NYSE's board of directors approved standards and changes in the corporate governance and practices of NYSE-listed companies that were first announced on June 6, 2002. These new standards seek to further strengthen issuer accountability, integrity, and transparency. NYSE also views them as an opportunity to strengthen the checks and balances among investors, issuers, and the NYSE market. According to NYSE officials, it has harmonized its proposed listing standards with the provisions set forth in the Sarbanes-Oxley Act. On August 16, 2002, NYSE filed the proposed rule change with SEC for its approval. Some of the final changes would include the following:

- requiring corporate boards to have a majority of independent directors;

[75]Regulation FD is an issuer disclosure rule that addresses selective disclosure, 17 C.F.R. Part 243. It provides that when an issuer, or person acting on its behalf, discloses material nonpublic information to certain enumerated persons (in general, securities market professionals and holders of the issuer's securities who may well trade on the basis of the information), it must make public disclosure of that information.

- requiring that boards affirmatively determine that independent directors have no material relationship with the listed company;
- lengthening the "cooling-off" period for former employees and independent auditors before they could serve as an independent director of the company they worked for or audited;
- enhancing the independence requirements applicable to the independent audit committee, and increasing the authority and responsibility of that committee, including granting it the sole authority to hire and fire the independent auditors;
- requiring listed companies to have nominating, corporate governance, and compensation committees composed entirely of independent directors;
- requiring nonmanagement directors to meet at regularly scheduled executive sessions without management;
- requiring listed companies to have an internal audit function;
- requiring listed companies to adopt and disclose governance guidelines, codes of conduct and ethics, and charters with specified provisions for the independent audit, nominating, and compensation committees;
- requiring shareholder approval for equity compensation plans;
- requiring an annual CEO certification of compliance with NYSE corporate governance standards; and
- providing for NYSE to issue a public reprimand letter to a listed company that violates an NYSE governance listing standard, although delisting remains the ultimate penalty.

Although Nasdaq's and NYSE's proposed changes to their listing standards are important and positive steps, more could be done to strengthen corporate governance. For example, the proposals do not require a supermajority of independent directors, do not specifically bar a CEO from serving as chairman of the board of directors, could more broadly address interlocking directorships, and do not require that key board committees have their own resources and access to independent advisers as and when they deem necessary.[76] As these standards are being reviewed and finalized, we believe these issues continue to deserve ongoing consideration by the stock markets and SEC, as appropriate.

Finally, SEC is again exploring whether additional oversight could apply as a condition to being recognized as an NRSRO. In 1994, SEC issued a concept release requesting public comment on the appropriate role of credit ratings in the federal securities laws, and the need to establish formal procedures for designating and monitoring the activities of NRSROs.[77] In response to comments on this release, in 1997, SEC proposed a rule that would have adopted a definition of the term NRSRO that set forth the criteria a rating organization would have to satisfy to be acknowledged as an NRSRO. To date, there has been no action on this proposal.[78]

SEC Faces Ongoing Human Capital Resources, Technology, and Process Challenges

Effectively managing its human capital resources, technology, and processes is likely to remain a challenge for SEC in the future. As we reported earlier this year, SEC faces challenges in effectively carrying out its regulatory activities because of existing workload and staffing imbalances.[79] In particular, we found that SEC's ability to review corporate filings has been strained, resulting in fewer corporate filings being reviewed each year. Likewise, we found that the number of enforcement actions pending at the end of the year had increased substantially. SEC officials noted that these circumstances were also due to the increasing

[76]Both proposals address resources for audit committees, but do not require that other committees also have their own resources. According to NYSE officials, its proposal suggests that companies "should" provide key committees with their own resources .

[77]See SEC Release No. 34-34616.

[78]See SEC Release No. 34-39457.

[79]GAO-02-302.

complexity of accounting and disclosure, which require more time to review filings and investigate matters. In addition to increasing workloads, CorpFin and Enforcement have had to manage high turnover rates and large numbers of staff vacancies.[80] SEC's current experience with hiring additional staff (authorized by its supplemental appropriation for its fiscal year 2002) illustrates that SEC is likely to face ongoing challenges in filling many of these positions, especially accountants. The supplemental appropriation gives SEC the authority to hire 100 additional staff, which according to SEC, would be best filled by primarily hiring accountants. SEC officials stated that while they are committed to hiring a significant number of accountants with the supplemental appropriation, the personnel process required for hiring accountants is more time consuming and cumbersome than the process for hiring attorneys.[81] They added that this might result in SEC hiring more attorneys to fill the currently available positions.

In addition to challenges in recruiting and hiring staff, SEC faces ongoing human capital management challenges, as discussed in our September 2001 report—which found that although compensation was the primary reason staff left or would consider leaving SEC, SEC has other human capital challenges to address.[82] SEC now has pay parity, the ability to pay employees on par with other federal banking agencies.[83] When funded and fully implemented pay parity should help SEC attract and retain staff, but higher compensation alone cannot solve SEC's retention challenges in the future. Because SEC's employees can always opt for higher private-sector pay, SEC's efforts to enhance its human capital programs as a means to recruit and retain employees will become more important. For example, our 2001 survey of current and former SEC accountants, attorneys, and examiners provided useful information that SEC management can use to identify key opportunities to improve employee job satisfaction, including

[80]SEC's turnover of 9 percent in 2001 was lower than its 2000 rate but remained higher than the governmentwide rate. SEC also had hundreds of staff vacancies in 2001.

[81]Accountant positions must be filled competitively and are subject to various requirements as competitive service appointments while attorney positions are in the excepted service and are not subject to the same requirements.

[82]U.S. General Accounting Office, *Securities and Exchange Commission: Human Capital Challenges Require Management Attention*, GAO-01-947 (Washington, D.C.: Sept. 17, 2001).

[83]The Investor and Capital Markets Fee Relief Act, Pub. L. No. 107-123, exempts SEC from the provisions of Title 5 of the U.S. Code related to civil service compensation.

advancement opportunities, the appraisal process, the performance incentive system, and the work review process.

SEC also faces future challenges in the technology. As we identified in our SEC resources report, budgetary limitations have historically confined SEC's technology budget to fund hardware and software maintenance and technology infrastructure needs. The Sarbanes-Oxley Act authorized a budget increase that would begin to allow SEC to fund some of its existing unfunded technology needs, such as purchasing technology that would enhance the ability of reviewers to detect trends in corporate filings and better leverage SEC's limited staff. However, to effectively enhance SEC's technological base, SEC will need to develop a process to prioritize technology needs and explore ways to more fully utilize available technology that will allow it to leverage existing staff resources. According to SEC officials, this is an area that SEC had not fully explored due to resource constraints but holds promise for strengthening the agency's regulatory efforts in the future. Moreover, additional funding in this area may enable SEC to reinvigorate certain regulatory efforts, including enforcement and corporate filing reviews, by making greater and more effective use of technology.

Going forward, SEC also faces a number of process-oriented challenges as it attempts to rebalance its existing responsibilities, which include reviewing filings and enforcing securities laws, with its new responsibilities under the Sarbanes-Oxley Act. An effective strategic planning process is particularly important to help SEC stay abreast of ongoing and future challenges. As we reported in March 2002, SEC had not engaged in a comprehensive strategic planning process that would enable it to proactively manage its dynamic regulatory responsibilities.[84] However, since that time, SEC has taken the first step in developing a comprehensive process by engaging a consulting firm to help it review existing operations. Once this review is complete, SEC will be in a position to develop a dynamic comprehensive strategic planning process that better addresses its mission goals and staffing needs.

Finally, the Sarbanes-Oxley Act increases the demands placed on SEC to effectively manage its human capital resources and put processes in place that will allow it to effectively carry out its new duties and responsibilities that are important to restoring and maintaining shareholder confidence in

[84] GAO-02-302.

U.S. markets. Among the most important of SEC's new responsibilities is its role in the oversight of the Board, which in turn is charged with overseeing the accounting profession. As mentioned earlier, SEC has always had an important role in overseeing the financial reporting process. However, in the future SEC will have increased responsibilities associated with the role it is expected to play in ensuring that the Board effectively discharges its duties.

Observations

The significant increase in the number of financial statement restatements and their impact on markets, shareholders, and employees, raise a number of important questions that warrant further analysis but were beyond the scope of this review. These questions include determining (1) which public accounting firms audited the 919 restatements we identified, (2) whether they were new or existing auditors, (3) what role the auditors played in identifying the issue that resulted in the restatement, and (4) whether the auditors raised concerns about any questionable accounting practices before the restatement. We plan to address many of these questions and similar issues in our ongoing work in this area, which includes a study on mandatory audit rotations required by the Sarbanes-Oxley Act. In addition, our analysis of SEC's enforcement actions involving accounting-related cases also raises questions about the adequacy and timeliness of SEC's activity in this area and the sanctions being sought by SEC in light of the violations. The Sarbanes-Oxley Act requires that SEC complete two studies on violators and violations, including individuals and entities that have and have not been charged, and enforcement actions involving financial report violations imposed over the past 5 years. These studies should provide additional information and analysis that will expand on that done in this report.

The limitations discussed concerning the current governance and oversight structure raise issues that must also be addressed as the new structure is being implemented. Effective governance structures composed of highly qualified individuals are key to the success of any organization and system on which others must rely. In this regard, several factors are important to the successful implementation of this new structure. First, members of the new oversight board must not only meet high qualifications and independence requirements, but also fully embrace the principles articulated in the act and the need for fundamental reform. Second, the Board, once established, should provide active and ongoing input to the accounting profession. Third, the Board must ensure that meaningful audit standards are adopted and that they are being followed. Fourth, the Board

should ensure that its policies and actions are structured so as to encourage all parties to "do the right thing." Fifth, the Board should ensure that a reasonable degree of transparency exists in connection with its actions and activities. Finally, the Board must swiftly and appropriately punish wrongdoers.

Agency Comments and Our Evaluation

The Director, CorpFin, provided written comments on a draft of this report that are reprinted in appendix II. SEC commented that the report was thorough and reiterated several of our major findings. First, SEC commented about the difficulty of isolating the impact of restatements on market capitalization, but noted that our thorough methodology and review of available resources gives the most complete picture feasible. SEC also agreed that the report identified and confirmed a number of important developments. Specifically, SEC listed the significant increase in restatements, the increase in the number of large companies restating, and the fact that revenue recognition and improper expense accounting are among the most common reasons for restating. Second, SEC stated that it is fully committed to the rule-making and other activities needed to fully implement "the letter and spirit of the Act." SEC added that it is particularly mindful of our observations concerning the selection of members of and implementation of the Board. Third, SEC noted that the quantitative work in this report lays the groundwork for its mandated study on SEC enforcement actions involving violations of reporting requirements over the past 5 years. Finally, SEC expressed its commitment and resolve, given the additional resources that the Sarbanes-Oxley Act identified as necessary for SEC to carry out its responsibilities, to meet its ongoing human capital, technology, and process challenges.

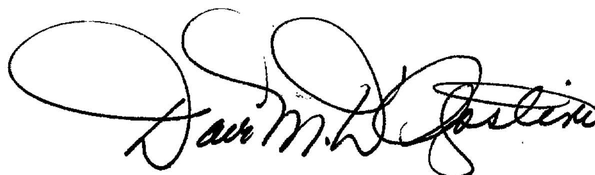
We requested and received technical comments from officials of NASD, Nasdaq, NYSE, and Amex on selected excerpts of a draft of this report and incorporated their comments into this report as appropriate.

We also requested comments on drafts of the cases from the 16 companies selected as case studies. We received technical comments from 8 of the 16 companies and incorporated their comments into this report as appropriate. The remaining eight companies either informed us that they had "no comments" or did not respond to our request.

As agreed with your office, we plan no further distribution of this report until 30 days from its issuance unless you publicly release its contents sooner. At that time, we will send copies of this report to the Ranking Minority Member of the Senate Committee on Banking, Housing, and Urban Affairs; the Chairman and Ranking Minority Member of the Senate Subcommittee on Securities and Investment, Senate Committee on Banking, Housing, and Urban Affairs; the Chairman and Ranking Minority Member, Senate Committee on Governmental Affairs; the Chairman and Ranking Minority Member, House Committee on Financial Services; and other interested congressional committees. We will also send copies to the Chairman of SEC and will make copies available to others upon request. In addition, this report is also available on GAO's Web site at no charge at http://www.gao.gov.

If you or your staff has any questions regarding this report, please contact Ms. Orice M. Williams or me at (202) 512-8678.

Sincerely yours,



Davi M. D'Agostino
Director, Financial Markets and
Community Investment

Objectives, Scope, and Methodology

As agreed with your staff, our objectives were to (1) determine the number of, reasons for, and other trends in financial statement restatements since 1997; (2) analyze the impact of restatement announcements on the restating companies' stock market capitalization; (3) research available data to determine the impact of financial statement restatements on investors' confidence in the existing U.S. system of financial reporting and capital markets; (4) analyze the Securities and Exchange Commission (SEC or Commission) enforcement actions involving accounting and auditing irregularities; and (5) describe the major limitations of the existing oversight structure and steps that have been and are being taken to ensure the integrity of corporate financial disclosures and ongoing challenges.

Identifying the Number of and Reasons for Financial Statement Restatements

To determine the number of and reasons for financial statement restatements since 1997, we identified financial statement restatements announced from January 1, 1997, through June 30, 2002, using the Lexis-Nexis online information service to search for press releases and other media coverage on financial statement restatements. When developing our search methodology for identifying financial statement restatements, we reviewed the approaches used in several academic and nonacademic research papers.[85] Using the Lexis-Nexis "Power Search" command and the "US News, Combined" database, we performed a keyword search using "restate," "restates," "restated," "restating," or "restatement" within 50 words of "financial statement" or "earnings." We also used other variations such as "adjust" and "amend" and "revise." In addition, we included some restatements identified through other sources such as SEC.

To our knowledge no comprehensive, authoritative database of financial statement restatements exists. While several academic and nonacademic researchers have constructed and maintained their own financial statement

[85]Our sources included Financial Executives International (FEI) and M. Wu, 2001, "Quantitative Measures of the Quality of Financial Reporting," Internet-Based Special Report, FEI Research Foundation; Jickling, M., 2002, "Accounting Problems Reported in Major Companies Since Enron," Congressional Research Service (CRS) Report for Congress; Palmrose, Z.V., V. Richardson, and S. Scholz, 2002, "Determinants of Market Reactions to Restatement Announcements," Working Paper, University of Southern California; Palmrose, Z.V., and S. Scholz, 2002, "Accounting Causes and Litigation Consequences of Restatements," Working Paper, University of Southern California; Huron Consulting Group (HCG), 2002, "A Study of Restatement Matters," Internet-Based Report, Huron Consulting Group; Turner, L., J. Dietrich, K. Anderson, and A. Bailey, 2001, "Accounting Restatements," Working Paper, SEC; and Wu, M., 2002, "Earnings Restatements: A Capital Market Perspective," Working Paper, New York University.

restatement databases, these lists are generally proprietary and are not publicly available. Moreover, these researchers use different methods and criteria for constructing their databases, as well different sample periods, making it difficult to directly compare the database of financial statement restatements that we constructed with the databases that others have compiled.[86] Because we were unable to determine its relative completeness or accuracy, our database, which included 919 restatement announcements, should be viewed as a sample of financial statement restatements identified using our particular search methodology and the results of our analysis should be viewed in this context.

Although there are many reasons for financial statement restatements, most restatements are routine and do not indicate accounting irregularities. We specified accounting irregularities to include so-called “aggressive” accounting practices, intentional and unintentional misuse of facts applied to financial statements, oversight or misinterpretation of accounting rules, and fraud. Also, we included each restatement, regardless of its impact on the restating company’s financials, in our database.

However, we excluded restatement announcements that resulted from normal corporate activity or simple presentation issues—unless there was some irregularity involved. For example, we excluded financial statement restatements resulting from mergers and acquisitions, discontinued operations, stock splits, issuance of stock dividends, currency-related issues (for example, converting from Canadian dollars to U.S. dollars), changes in business segment definitions, changes due to transfers of management, changes made for presentation purposes, general accounting changes under generally accepted accounting principles (GAAP), litigation settlements, and arithmetic and general bookkeeping errors. As a general rule, we also excluded restatements resulting from accounting policy changes.[87] We excluded these financial statement restatements because they did not necessarily reveal previously undisclosed, economically meaningful data to market participants.

[86]We were able to crosscheck portions of our list with lists compiled by CRS, SEC, and Turner *et al.*

[87]Based on discussions with SEC officials, we included restatements that stemmed from the issuance of SEC Staff Accounting Bulletin No. 101 (SAB 101), “Revenue Recognition in Financial Statements—Frequently Asked Questions and Answers,” (December 3, 1999). According to SEC officials, SAB 101 represented a clarification of existing guidance and any resulting restatement would have been to correct a previous misstatement of financial reports.

Once a relevant restatement was identified, we classified it into 1 or more of 13 categories based on the information presented in the initial restatement announcement and collected other relevant information.[88] For purposes of analysis, we further collapsed these 13 categories into 9 categories—(1) acquisition and merger related; (2) cost or expense related; (3) in-process research and development related; (4) reclassification; (5) related-party transactions; (6) restructuring, assets, or inventory; (7) revenue recognition; (8) securities related; and (9) other.[89] Our classification closely resembles that employed by FEI and Wu (2001) and HCG (2002). Finally, to determine characteristics of the companies restating their financial reports, we collected information on market capitalization values, total assets, and Standard Industrial Classification codes for the restating companies we identified.

Determining the Impact of Financial Statement Restatements on Market Values of Restating Companies

To analyze the impact of restatement announcements involving accounting irregularities on the stock market value of restating companies, we used the standard event study approach. The event to be measured was the initial announcement from January 1, 1997, to March 26, 2002, of a financial statement restatement involving accounting irregularities by a publicly traded company with common stock issued on the New York Stock Exchange (NYSE), National Association of Securities Dealers Automated Quotation (Nasdaq) National Market System or SmallCap venue, American Stock Exchange (Amex), or the over-the-counter (OTC) bulletin board or Pink Sheets. Throughout, we refer to the subset of companies with stock traded on NYSE, Nasdaq, and Amex as “listed.” We obtained historical stock price data for the relevant listed companies from NYSE’s Trade and Quote (TAQ) database. This database contains detailed records of all

[88]We subsequently used SEC’s Electronic Data Gathering Analysis and Retrieval database—through which public companies electronically file registration statements, periodic reports, and other forms—to verify certain information provided in company press releases and press articles.

[89]Some restatement announcements cited multiple accounting issues (for example, improper revenue recognition, improper recording of cost of goods sold, and improper valuation of inventory). In these cases, we included the restatement in all applicable categories, and in the analyses involving stratification by restatement reason, we assigned equal fractional weights to the reasons. For the above example, we would assign each reason (revenue, cost/expense, and restructuring/assets/inventory) a weight of one-third when calculating the market capitalization loss.

quotes and transactions made for all NYSE, Nasdaq NMS and SmallCap, and Amex issues.[90]

Although we identified 919 restatement announcements from January 1, 1997, to June 30, 2002, we excluded some restatements from our analysis for a number of reasons. First, we excluded restatements by companies with stock traded on the OTC bulletin board or Pink Sheets because we did not have access to reliable historical price data for these stocks. We estimated that the exclusion of these unlisted companies would have a negligible impact on our market capitalization results, as companies with stock traded on the OTC bulletin board and Pink Sheets tend to be smaller in terms of market capitalization, but it is not clear whether their exclusion will introduce positive or negative bias in our average holding period abnormal returns results. Secondly, we excluded initial restatement announcements after March 26, 2002, the last trading day covered by our TAQ data subscription that allowed us to perform the necessary calculations for our analysis. Finally, we excluded from our analysis any restatement by a company that had extensive portions of data missing during the relevant time period around the restatement announcement. Missing data were generally attributable to extended trading suspensions, stock delistings, bankruptcies, and mergers.[91] However, TAQ was also missing data for several listed companies; thus, we excluded these companies from our analysis. We cannot estimate the impact that these exclusions would have on our reported results. To the extent a company's stock price declined following delisting, our analysis would be biased toward understating the impact of financial statement restatement announcements. To address these issues, we performed separate analyses on subsets of these cases using alternative stock price data.

To determine the impact of the restatement announcement on a company's stock price, we identified the trading day that corresponded with the initial announcement date. Although many companies announced their restatements during or before normal trading hours on a trading day, others

[90]To ensure the reliability of the TAQ data, we randomly cross-checked TAQ data with data provided by Nasdaq, Yahoo! Finance, and other publicly available stock data sources.

[91]Companies announcing financial restatements frequently were forced to delay their required SEC filings or were in violation of other listing standards and were subsequently delisted from NYSE, Nasdaq, or Amex within 60 trading days of the restatement announcement. In some cases, the stock of the delisted company moved to the OTC bulletin board or Pink Sheets. In several cases, these companies ultimately filed for bankruptcy or were acquired by other companies.

publicly announced their financial statement restatement after the close of trading or on a nontrading day. In these cases, we defined the announcement day as the next trading day. We then identified the relevant trading days before and after the restatement announcement, collectively known as the event window. To analyze the immediate impact of financial statement restatement announcements, we specified the immediate event window as the period from the trading day before the announcement through the trading day after the announcement. To analyze the longer-term impact of restatement announcements, we also specified an intermediate event window of approximately 6 calendar months, which included 60 trading days (3 months) before the announcement through 60 trading days (3 months) after the announcement.[92]

To assess the impact of the restatement announcement on a company's stock price, we calculated the "abnormal return" of the stock over the event window. The abnormal return is the realized rate of return of a stock over the event window minus the expected return of that stock over the same period. The realized, or actual, rate of return of a stock of company i from date t–1 to date t is defined as

$$\frac{P_{it} - P_{i,t-1}}{P_{it-1}} + \frac{D_{it}}{P_{i,t-1}}$$

in which P_{it} is the closing price of the stock at date t, $P_{i,t-1}$ is the closing price of the stock at date t–1, and D_{it} reflects any dividend payment made at date t. The expected return is defined as the rate of return of the stock (predicted by some valuation model) that is expected under the assumption that the event does not occur. In this way, the abnormal return is designed to capture the impact of the event on the stock. For any company i and date t,

$$A_{it} = R_{it} - \mathrm{E}(R_{it} \mid X_t)$$

in which A_{it} is the abnormal return of the stock of company i on date t, R_{it} is the realized return of the stock of company i on date t, and $E(R_{it}|X_t)$ is the expected return of the stock of company i on date t conditioned on some

[92]We included the trading days prior to a restatement announcement to address possible information leakage prior to the announcement.

information set, X_t. We used the rate of return of the Wilshire Total Market Index on date t as our conditioning information, X_t.[93]

To calculate the abnormal return, we first specified a statistical model for estimating the expected return of the stock of company i on date t. We used a standard market model, which relates the rate of return of the stock of i to the return of the overall market as

$$R_{it} = \alpha_i + \beta_i X_t + \varepsilon_{it}$$

in which ε_{it} is an error term and α_i and β_i are the parameters of the market model. In this specification, α_i and β_i are the intercept and slope, respectively, of the linear relationship between the return of the stock of company i on date t and the return of the market on date t.[94] The parameter, β_i, is a measure of the covariation between the returns of the stock of i and the returns of the market. In this way, the expected return is risk-adjusted, taking into account the risk of stock i relative to the overall market. Next, we estimated the parameters of the model using a subset of the data. This subset, referred to as the "estimation window," included approximately 120 trading days (typically about 6 calendar months) of daily closing price data through the day prior to the initial restatement announcement.[95] We estimated the market model using the ordinary least squares estimation procedure for each of the companies for which we had sufficient data. Each estimation produced parameter estimates for α_i and β_i, a_i and b_i respectively, for the given company and estimation window. The parameter estimates were subsequently used to generate an estimate of the expected return, $E(R_{it}|X_t)$, for each stock i at each date t using the market model. This estimate of the expected return, N_{it}, was determined as

$$N_{it} = a_i + b_i X_t$$

Using this expected return, we also calculated an estimate of the expected stock price for each stock i at each date t, Q_{it}, as

[93]Wilshire Associates Incorporated, an investment advisory company, provides widely quoted and tracked market indices.

[94]In a standard financial econometrics text, Campbell, Lo, and MacKinlay (1997) provide a detailed discussion of the market model. While the market model we use is very simple, according to these authors it is not clear that using a more sophisticated model is necessary.

[95]The event itself is not included in the estimation window so that the event does not influence the estimates of the model's parameters.

$$Q_{it} = P_{i,t-1} \times (1 + N_{it}) = P_{i,t-1} \times (1 + a_i + b_i X_t)$$

We then calculated the abnormal return for each stock based on the results of our estimation. For any company i and date t, the estimated abnormal return, L_{it}, was

$$L_{it} = R_{it} - (a_i + b_i X_t) = R_{it} - N_{it}$$

We also calculated the estimated unexpected, or market-adjusted, change in the stock price of i from t–1 to t, U_{it}, as

$$U_{it} = P_{it} - Q_{it} = P_{it} - P_{i,t-1} \times (1 + N_{it}) = P_{it} - P_{i,t-1} \times (1 + a_i + b_i X_t)$$

To measure the impact of the restatement announcement on the stock of company i, we calculated the abnormal return over the holding period from day –1 to day +1 to capture the immediate impact, and we calculated the abnormal return over the holding period from day –60 to day +60 to capture the intermediate impact. We also calculated the immediate impact on the market capitalization of company i by multiplying the difference between the actual stock price on day +1 and the expected price on day +1 (the immediate market-adjusted change in price) by the number of shares outstanding, and we calculated the intermediate impact on the market capitalization of company i by multiplying the difference between the actual stock price on day +60 and the expected price on day +60 (the intermediate market-adjusted change in price) by the number of shares outstanding.[96] To assess the overall impact of the general event of a restatement announcement, we averaged individual holding period abnormal returns over all restatement announcement events in our sample for both the immediate and intermediate time frames, and we summed all

[96]We obtained the number of shares outstanding for a company from the company's Form 10-Q covering the 3-month period during which the restatement announcement was made. If this were not available, we used either the closest Form 10-Q, appropriate Form 10-K, or other company sources. Specifically, we obtained the average number of diluted shares over this period. Diluted shares are the pools of common shares outstanding issued by a company, combined with the shares that would be created upon the conversion of the company's options, warrants and convertible securities. Our use of diluted rather than basic shares provides a more accurate assessment of the overall impact on shareholders.

of the unadjusted and adjusted market changes in price for both the immediate and intermediate time frames.[97]

For the companies that dropped out of our sample from the immediate to the intermediate event window due to trading suspensions, delistings, bankruptcies, and mergers, among other reasons, we attempted to capture the longer-term impact of their financial restatement announcements in a separate analysis using unadjusted data. For each such company, we identified its status approximately 3 months after its initial restatement announcement using Lexis-Nexis and other sources—whether it was a going concern, bankrupt, or merged with or was acquired by another company. If a company were a going concern, we estimated its market capitalization using publicly available data from Nasdaq or Pink Sheets and SEC, and estimated the change in market value from 60 trading days before the restatement announcement. If a company went bankrupt, we estimated the loss in market capitalization by assuming a total loss. We did not attempt to estimate the impact for a company that merged with or was acquired by another company.

The usual interpretation of abnormal returns over an event window is that they measure the impact of the event on the value of a company's stock. This interpretation may be misleading due to other firm-specific or market factors. Our simple market model attempted to account for only the overall market's effect on the stock. One of the more relevant factors in this event study was the simultaneous release of the restatement announcement and scheduled financial statements to the market. For example, a company may have issued its first quarter 2000 earnings that could have missed, met, or exceeded the market's expectations while also announcing that it was restating previously issued financial statements from 1998 and 1999. To the extent that this was an issue, our results could be biased in either direction and, hence, attributing abnormal returns solely to the restatement announcement could be misleading. Another potential factor is information leakage. Events such as the announcement of an SEC inquiry, internal or external accounting review, or abrupt departure of a company's chief executive officer or chief financial officer may be an early indication that a financial restatement is forthcoming. Furthermore, it is important to note

[97]We also calculated the individual cumulative abnormal returns for each case and the cumulative average abnormal return overall, and our results for the immediate event window were similar to those reported using holding period abnormal returns. Campbell, Lo, and MacKinlay (1997) detail this alternative method.

that as we increase the time period over which we attempt to assess the impact of the restatement on a particular stock, there can be many other factors influencing the behavior of the stock price. To the extent that other influences on the price are significant, our intermediate results reflect not only the impact of the restatement announcement but these factors as well.

Additionally, there are potential sources of bias in our estimation procedure. Some of the more important involve event-date uncertainty, violations of our statistical assumptions, and using daily closing stock prices. While our event study methodology assumes that we are able to precisely identify the event date with certainty, this sometimes involved a certain amount of judgment. The announcement of a financial statement restatement typically only provides the date of the announcement; whether the announcement was made before, during, or after trading on that date may not be clear. Another possible source of bias stems from violation of our standard statistical assumptions.[98] A further potential source of bias in our estimation involves using the daily closing prices of stocks. In the event study framework, we implicitly assumed that these daily closing prices were recorded at identical time intervals each day. However, this assumption is easily violated because the last transaction for a given stock can and generally does occur at a different time each day. Additionally, some of the stocks in our event study were “thinly” or infrequently traded, and several days could elapse between transactions. Referring to the last recorded prices as daily closing prices assumed that closing prices are equally spaced at 24-hour intervals, which is not the case. To the extent that this assumption is violated, our results may be biased.

Overall, our analysis focused on the impact of a company’s restatement announcement on its market capitalization. Therefore, we did not take into account the effects on market participants with short positions or various options positions, nor did we gauge the impact on the company’s bondholders. To whatever extent—whether positively or negatively—these market participants were affected by financial statement restatements, our results are necessarily incomplete.

[98]See Campbell, Lo, and MacKinlay (1997).

Determining the Impact of Financial Statement Restatements on Investor Confidence

To analyze impact of financial statement restatements on the confidence of market participants, we relied principally on outside sources. Namely, we identified indexes of investor confidence, located quantitative research on the issue, conducted interviews with experts in the field and collected data on mutual fund flows as a proxy for investor sentiment. The survey-based indexes of investor confidence were obtained from UBS Americas, Inc., and the International Center for Finance at the Yale School of Management. The Nobel Laureate economist, Dr. Lawrence Klein, acknowledged the UBS Index for its accuracy and timeliness. The Yale School of Management Indexes are considered to be the longest running effort to measure investor confidence and the project is directed by one of the leading experts in the field, Dr. Robert Shiller. We were also able to collect survey results about the direct impact of restatements on investor confidence from UBS Americas. Although the literature on the impact of restatements on investor confidence is sparse, we identified two such studies. The results of both studies were consistent with the hypothesis that investor confidence has been negatively impacted by financial statement restatements. However, we were not able to quote or cite one study, as the results were preliminary at the time of this report's issuance. To gain further insight, we also interviewed some experts in the field and summarized their responses to a set of questions regarding accounting practices, financial statement restatements and investor confidence. Finally, we collected data on mutual fund flows from the Investment Company Institute, a popular source for statistical data on the mutual fund industry.

Analysis of SEC's Accounting-Related Enforcement Activities

To analyze SEC enforcement actions involving accounting and auditing irregularities, we reviewed 150 SEC-identified Accounting and Auditing Enforcement Releases (AAER)[99] issued from January 1, 2001, through February 28, 2002. For these cases we identified the most common types of accounting and auditing-related securities law violations, against whom SEC enforcement actions have been brought recently, and the type of penalties imposed by SEC. We defined "most common" as violations constituting more than 20 percent of the total number of violations we found in the 150 AAERs. Because multiple individual are often sanctioned, we did not include all individual parties named in the AAER when determining the frequency of a violation. For example, AAERs in which two

[99]AAERs are used by SEC staff to catalog accounting-related civil or administrative actions. For a detailed listing of the AAERs included in our analysis, please see appendix XXI.

individuals were charged with the same securities violation, were counted as one violation for purposes of analysis. We also collected other common information disclosed in the AAERs such as the individuals and companies charged in the cases and the sanctions levied. To describe the process that SEC uses to develop an enforcement case, including whom to include as a defendant in the case and penalties to assess, we used a variety of information provided by SEC and interviews with officials from SEC's Divisions of Enforcement and Corporation Finance[100] and Office of the Chief Accountant. To obtain historical general enforcement and accounting-related enforcement actions, we also used summary AAER analysis done by SEC for fiscal years 1999 and 2000 and SEC annual reports.

Collecting Information on Current and Proposed Accounting and Financial Reporting Oversight Structures

To describe the current regulatory, corporate and market approaches to protecting investors and ensuring capital market integrity, we reviewed relevant GAO reports and testimonies, SEC testimonies and speeches, published articles, congressional hearings documents, and other available information. We also interviewed various SEC officials and reviewed the federal securities laws. To determine proposed regulatory approaches to protect investors and ensure capital market integrity, we reviewed relevant proposals from GAO, SEC, private self-regulatory bodies (e.g., NYSE), Congress, academia, and others. To gain a better understanding of SEC's statutory authority to bring enforcement action against securities analysts and credit rating agencies and any action taken against them, we interviewed officials of SEC's Divisions of Enforcement, Investment Management, and Market Regulation; and we reviewed the federal securities laws. To the extent possible, we determined the roles that key players, such as auditors and company senior management played. We selected 16 financial restatements for in-depth case study. The cases were selected based on asset size, restatement period, percentage change in earnings following the restatement, reason for the restatement, and market where stock traded.

We did our work in Washington, D.C., between February and September 2002, in accordance with generally accepted government auditing standards.

[100]If the Division of Corporation Finance through its review process of companies' filings becomes aware of securities laws violations by companies, it can make enforcement referrals to Enforcement.

Comments from the Securities and Exchange Commission

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

DIVISION OF
CORPORATION FINANCE

September 20, 2002

Thomas J. McCool
Managing Director, Financial
Markets and Community Investment
U.S. General Accounting Office
Washington, D.C. 20548

Dear Mr. McCool:

Thank you for the opportunity to review and comment on the General Accounting Office's draft report entitled "Financial Statement Restatements: Trends, Market Impacts, Regulatory Responses, and Remaining Challenges." We recognize the efforts of you and your staff in completing this thorough review on such an expedited basis, and we thank you for sharing your findings with us.

Isolating the impact of restatements on market capitalization is a very difficult endeavor, especially in the ever-changing circumstances faced by companies in our nation's markets. We believe that your thorough methodology and review of the available sources and resources gives the most complete picture that is practically feasible of this difficult question. Your efforts are commendable, as are your efforts to determine the impact of financial statement restatements on investor confidence. Your study identified and confirmed a number of important developments: first, that the number of restatements has significantly increased in recent years; second, that the number of large company restatements has increased; and third, that errors in revenue recognition and improper expense accounting are among the most common reasons for financial statement restatement.

As your report notes, the SEC has sought to move promptly and vigorously in the light of these developments. The number of our cases involving financial reporting has increased in recent years, and is at record levels for 2002. We have been emphasizing "real-time enforcement", bringing cases as quickly as possible both to increase the deterrent effect of our enforcement activities and to reduce losses and increase recoveries to investors to the extent possible. We are also seeking disgorgement, officer and director bars and other important remedies at unprecedented levels. We are grateful you have acknowledged our effort to implement real time enforcement and the obstacles we continue to face in this effort. In carrying out these activities, we are part of the processes that the legislative and executive branches, regulators and self-regulators have put in motion to strengthen corporate governance, improve financial reporting and restore investor confidence.

Mr. Thomas J. McCool
Page Two

The Sarbanes-Oxley Act of 2002 represents the most far-reaching government response to date to the extremely troubling environment described in the Report. The SEC is fully committed to the rule-making and other activities that fully implement the letter and spirit of the Act. In that regard, we are, of course, particularly mindful of your observations regarding the selection of the members of and implementation of the provisions of the Act regarding the newly established Public Company Accounting Oversight Board. We are committed to assuring the effectiveness and integrity of this board and look forward to your report on the new structure.

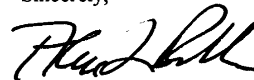
In addition, as you know, Section 704 of the Act requires the Commission to review and analyze Commission enforcement actions involving violations of reporting requirements imposed under the securities laws and restatements of financial statements over the past five years. Your report will provide valuable insight and assistance to the Commission in its implementation of this key provision. The purpose of the review is "to identify areas of reporting that are most susceptible to fraud, inappropriate manipulation or inappropriate earnings management." The quantitative work in your report lays the groundwork for us to carry out this important task.

We further note that, pursuant to the requirements of the Act, the GAO is called on to perform a study of mandatory audit rotation. We look forward to providing any assistance that you might seek from us in undertaking that study and look forward to working with you.

In addition, we appreciate your recognition of the ongoing human capital resources, technology and process challenges we face, especially in the areas of enforcement and review of public company disclosures. We are committed, given the additional resources that the Sarbanes-Oxley Act identifies as necessary for the Commission to carry out its responsibilities and our strong resolution to fulfill our responsibilities, to meet those challenges.

Thank you and your staff for the courtesy extended during this review.

Sincerely,



Alan L. Beller
Director

Listing of Financial Statement Restatement Announcements, 1997-June 2002

1997

1	Acacia Research Corporation
2	Alabama National BanCorp
3	America Online, Incorporated
4	American Business Information, Incorporated
5	American Standard Companies Incorporated
6	AMNEX, Incorporated
7	Ancor Communications, Incorporated
8	Arrhythmia Research Technology, Incorporated
9	Arzan International (1991) Limited
10	Ascent Entertainment Group, Incorporated
11	Astrocom Corporation
12	Caribbean Cigar Company
13	Carrington Laboratories, Incorporated
14	Centennial Technologies Incorporated
15	Computron Software, Incorporated
16	Concorde Career Colleges, Incorporated
17	Craig Consumer Electronics Incorporated
18	Discount Auto Parts Incorporated
19	Donnkenny, Incorporated
20	Dyna Group International Incorporated
21	Electrosource, Incorporated
22	Eltek Limited
23	Federal-Mogul Corporation
24	Fidelity Bancorp, Incorporated
25	Fine Host Corporation
26	First Colorado Bancorp, Incorporated
27	First Merchants Acceptance Corporation
28	First USA Paymentech, Incorporated
29	First USA, Incorporated
30	FOCUS Enhancements, Incorporated
31	Fonix Corporation
32	Foxmoor Industries Limited
33	Genesco Incorporated
34	Geographics, Incorporated

35	GranCare, Incorporated
36	Health Management, Incorporated
37	HealthPlan Services Corporation
38	Healthplex, Incorporated
39	HMI Industries Incorporated
40	Hudson Technologies Incorporated
41	In Home Health, Incorporated
42	Informix Corporation
43	InPhyNet Medical Management, Incorporated
44	International Nursing Services, Incorporated
45	Israel Land Development Company
46	Macerich Company
47	Management Technologies Incorporated
48	Material Sciences Corporation
49	Medaphis Corporation
50	Medaphis Corporation
51	Mercury Finance Company
52	Meridian National Corporation
53	Micro-Integration Corporation
54	Molten Metal Technology, Incorporated
55	MRV Communications, Incorporated
56	National Health Enhancement Systems, Incorporated
57	National Steel Corporation
58	National TechTeam, Incorporated
59	Oak Industries Incorporated
60	Paging Network, Incorporated
61	Paracelsus Healthcare Corporation
62	Pegasystems Incorporated
63	PennCorp Financial Group, Incorporated
64	Perceptron, Incorporated
65	Perceptronics, Incorporated
66	Photran Corporation
67	Physicians Laser Services, Incorporated
68	PictureTel Corporation
69	Room Plus, Incorporated
70	S3 Incorporated
71	Safe Alternatives Corporation of America, Incorporated
72	Santa Anita Companies

73 Silicon Valley Research, Incorporated
74 Simula, Incorporated
75 Soligen Technologies, Incorporated
76 St. Francis Capital Corporation
77 Summit Medical Systems, Incorporated
78 System Software Associates, Incorporated
79 Thousand Trails, Incorporated
80 Today's Man, Incorporated
81 Unison HealthCare Corporation
82 United Dental Care, Incorporated
83 Universal Seismic Associates, Incorporated
84 Unocal Corporation
85 UROHEALTH Systems, Incorporated
86 USA Detergents Incorporated
87 UStel Incorporated
88 Video Display Corporation
89 Waste Management Incorporated
90 WebSecure Incorporated
91 Wilshire Financial Services Group Incorporated
92 Wiz Technology, Incorporated

1998

93 3Com Corporation
94 4Health, Incorporated
95 ADAC Laboratories
96 Altris Software, Incorporated
97 American Skiing Company
98 Aspec Technology, Incorporated
99 AutoBond Acceptance Corporation
100 Boca Research, Incorporated
101 Boston Scientific Corporation
102 Breed Technologies, Incorporated
103 Cabletron Systems, Incorporated
104 Canmax Incorporated
105 Castelle Incorporated
106 Cendant Corporation
107 COHR Incorporated

108	Corel Corporation
109	Cotton Valley Resources Corporation
110	CPS Systems, Incorporated
111	Creative Gaming Incorporated
112	Cross Medical Products, Incorporated
113	CyberGuard Corporation
114	CyberMedia Incorporated
115	Cylink Corporation
116	Data I/O Corporation
117	Data Systems Network Corporation
118	Detection Systems, Incorporated
119	Digital Lightwave, Incorporated
120	Egobilt Incorporated
121	Envoy Corporation
122	EquiMed Incorporated
123	Female Health Company
124	Florafax International Incorporated
125	Food Lion, Incorporated
126	Forecross Corporation
127	Foster Wheeler Corporation
128	Galileo Corporation
129	General Automation, Incorporated
130	Glenayre Technologies, Incorporated
131	Golden Bear Golf, Incorporated
132	Green Tree Financial Corporation
133	Guilford Mills, Incorporated
134	Gunther International, Limited
135	H.T.E., Incorporated
136	Harnischfeger Industries
137	Hybrid Networks, Incorporated
138	Hybrid Networks, Incorporated
139	IKON Office Solutions Incorporated
140	Informix Corporation
141	Integrated Sensor Solutions, Incorporated
142	Interactive Limited
143	International Home Foods, Incorporated
144	International Total Services, Incorporated
145	Kyzen Corporation

146	Lernout & Hauspie Speech Products N.V.
147	Livent, Incorporated
148	McDonald's Corporation
149	MCI Communications Corporation
150	Media Logic, Incorporated
151	Mego Mortgage Corporation
152	Metal Management, Incorporated
153	Microelectronic Packaging Incorporated
154	Morrow Snowboards Incorporated
155	MSB Financial Corporation
156	National HealthCare Corporation
157	Neoware Systems, Incorporated
158	Newriders Incorporated
159	Norland Medical Systems, Incorporated
160	Outboard Marine Corporation
161	Pegasystems Incorporated
162	Peritus Software Services, Incorporated
163	Peritus Software Services, Incorporated
164	Philip Services Corporation
165	Physician Computer Network, Incorporated
166	Premier Laser Systems Incorporated
167	Prosoft I-Net Solutions, Incorporated
168	Raster Graphics, Incorporated
169	Room Plus, Incorporated
170	Rushmore Financial Group Incorporated
171	Saf T Lok Incorporated
172	Schlotzsky's Incorporated
173	ShoLodge, Incorporated
174	Signal Technology Corporation
175	SmarTalk Teleservices, Incorporated
176	Sobieski Bancorp Incorporated
177	Starbase Corporation
178	Starmet Corporation
179	Sterling Vision Incorporated
180	SunTrust Banks, Incorporated
181	Sunbeam Corporation
182	Sybase Incorporated
183	Telxon Corporation

184 Total Renal Care Holdings, Incorporated
185 Transcrypt International, Incorporated
186 Trex Medical Corporation
187 TriTeal Corporation
188 Unitel Video, Incorporated
189 Universal Seismic Associates, Incorporated
190 USWeb Corporation
191 Versar, Incorporated
192 Versatility Incorporated
193 Vesta Insurance Group Incorporated
194 Wheelabrator Technologies Incorporated

1999

195 Acorn Products, Incorporated
196 Advanced Polymer Systems, Incorporated
197 Aegis Communications Group, Incorporated
198 Allied Products Corporation
199 Alydaar Software Corporation
200 America Service Group Incorporated
201 American Bank Note Holographics
202 American Banknote Corporation
203 AmeriCredit Corporation
204 Annapolis National Bancorp
205 Armor Holdings, Incorporated
206 Assisted Living Concepts, Incorporated
207 Assisted Living Concepts, Incorporated
208 At Home Corporation
209 Autodesk, Incorporated
210 Avid Technology, Incorporated
211 AvTel Communications Incorporated
212 Aztec Technology Partners, Incorporated
213 Baker Hughes Incorporated
214 Bausch & Lomb, Incorporated
215 BellSouth Corporation
216 Belmont Bancorp
217 Best Buy Incorporated
218 Blimpie International, Incorporated

219	Blue Rhino Corporation
220	BMC Software, Incorporated
221	Boston Chicken Incorporated
222	Cabletron Systems, Incorporated
223	Candence Design Systems, Incorporated
224	Candie's Incorporated
225	Carleton Corporation
226	Carnegie International Corporation
227	CellStar Corporation
228	CenterPoint Properties Trust
229	Central Illinois Bancorp, Incorporated
230	CHS Electronics, Incorporated
231	CMGI Incorporated
232	Colorado Casino Resorts, Incorporated
233	Community West Bancshares
234	CompUSA Incorporated
235	CoreCare Systems, Incorporated
236	Crown Group, Incorporated
237	Cumetrix Data Systems Corporation
238	CVS Corporation
239	Cyberguard Corporation
240	Dassault Systemes S.A.
241	Day Runner, Incorporated
242	DCI Telecommunications, Incorporated
243	Digi International Incorporated
244	Discreet Logic, Incorporated
245	Diversinet Corporation
246	DSI Toys, Incorporated
247	Dynamex Incorporated
248	Engineering Animation, Incorporated
249	Engineering Animation, Incorporated
250	Evans Systems, Incorporated
251	Fair Grounds Corporation
252	FCNB Corporation
253	Fidelity National Corporation
254	Financial Security Assurance Holdings Limited
255	Finova Group, Incorporated
256	First Union Real Estate Equity and Mortgage Investments

257 First Union Real Estate Equity and Mortgage Investments
258 FlexiInternational Software, Incorporated
259 Flowers Industries Incorporated
260 Forest City Enterprises, Incorporated
261 Friedman's Incorporated
262 GameTech International, Incorporated
263 Gencor Industries, Incorporated
264 GenRad, Incorporated
265 Graham-Field Health Products, Incorporated
266 GTS Duratek, Incorporated
267 Gunther International, Limited
268 Halifax Corporation
269 Harken Energy Corporation
270 High Plains Corporation
271 Hitsgalore.com, Incorporated
272 Hungarian Broadcasting Corporation
273 Image Guided Technologies, Incorporated
274 IMRglobal Corporation
275 IMSI, Incorporated
276 Infinium Software, Incorporated
277 InfoUSA
278 INSO Corporation
279 Intasys Corporation
280 INTERLINQ Software Corporation
281 International Total Services, Incorporated
282 ION Networks, Incorporated
283 Kimberly-Clark Corporation
284 Lab Holdings, Incorporated
285 LabOne, Incorporated
286 Leisureplanet Holdings, Limited
287 Level 8 Systems
288 Lightbridge, Incorporated
289 LSI Logic Corporation
290 Lycos, Incorporated
291 Made2Manage Systems, Incorporated
292 Maxim Group, Incorporated
293 McKesson HBOC, Incorporated
294 MCN Energy Group, Incorporated

295	Medical Graphics Corporation
296	Medical Manager Corporation
297	Medical Waste Management
298	MEMC Electronic Materials, Incorporated
299	Metrowerks Incorporated
300	Miller Industries, Incorporated
301	Motorcar Parts & Accessories, Incorporated
302	National Auto Credit, Incorporated
303	National City Bancorp
304	Network Associates, Incorporated
305	Nichols Research Corporation
306	North Face, Incorporated
307	Northrop Grumman Corporation
308	Novametrix Medical Systems Incorporated
309	Nutramax Products, Incorporated
310	ObjectShare, Incorporated
311	ODS Networks, Incorporated
312	Olsten Corporation
313	Open Market, Incorporated
314	Open Text Corporation
315	Orbital Sciences Corporation
316	Orbital Sciences Corporation
317	Pacific Aerospace & Electronics, Incorporated
318	Pacific Research & Engineering Corporation
319	P-Com, Incorporated
320	PDG Environmental Incorporated
321	Pegasystems Incorporated
322	Peregrine Systems, Incorporated
323	Pharamaceutical Formulations, Incorporated
324	Protection One, Incorporated
325	PSS World Medical, Incorporated
326	Rite Aid Corporation
327	SafeGuard Health Enterprises, Incorporated
328	Safeskin Corporation
329	Safety Components International, Incorporated
330	SatCon Technology Corporation
331	Saucony, Incorporated
332	Schick Technologies, Incorporated

333	Schick Technologies, Incorporated
334	Segue Software, Incorporated
335	Signal Apparel Company, Incorporated
336	The Sirena Apparel Group, Incorporated
337	SITEK Incorporated
338	Smart Choice Automotive Group
339	SmarTalk TeleServices, Incorporated
340	Spectrum Signal Processing Incorporated
341	SS&C Technologies, Incorporated
342	Styling Technology Corporation
343	Sun Healthcare Group, Incorporated
344	Telxon Corporation
345	Texas Instruments Incorporated
346	The Timber Company
347	Thomas & Betts Corporation
348	Total Renal Care Holdings, Incorporated
349	TRW Incorporated
350	Twinlab Corporation
351	Unisys Corporation
352	Vesta Insurance Group Incorporated
353	Voxware, Incorporated
354	VTEL Corporation
355	Wabash National Corporation
356	Wall Data Incorporated
357	Wang Global
358	Warrantech Corporation
359	Waste Management Incorporated
360	WellCare Management Group Incorporated
361	Western Resources, Incorporated
362	Wickes Incorporated
363	Williams Companies
364	Xilinx, Incorporated
365	Yahoo! Incorporated
366	Zenith National Insurance Corporation
367	Ziegler Companies, Incorporated
368	Zions Bancorp

2000

369	1st Source Corporation
370	3D Systems Corporation
371	Able Telcom Holding Corporation
372	Acrodyne Communications, Incorporated
373	Activision, Incorporated
374	Advanced Technical Products, Incorporated
375	Aetna Incorporated
376	Allscripts Incorporated
377	Alpharma Incorporated
378	American Physicians Service Group, Incorporated
379	American Xtal Technology
380	Analytical Surveys, Incorporated
381	Anicom Incorporated
382	Asche Transportation Services, Incorporated
383	Aspeon, Incorporated
384	Atchison Casting Corporation
385	Auburn National Bancorp
386	Aurora Foods Incorporated
387	Avon Products, Incorporated
388	Aztec Technology Partners, Incorporated
389	Baan Company
390	BarPoint.com, Incorporated
391	Bindley Western Industries, Incorporated
392	Biomet, Incorporated
393	Bion Environmental Technologies, Incorporated
394	Boise Cascade Corporation
395	BPI Packaging Technologies, Incorporated
396	California Software Corporation
397	CareMatrix Corporation
398	Carnegie International Corporation
399	Carver Bancorp, Incorporated
400	Castle Dental Centers, Incorporated
401	Cato Corporation
402	Chesapeake Corporation
403	Children's Comprehensive Services, Incorporated
404	CIMA LABS Incorporated

405	CINAR Corporation
406	Clearnet Communications Incorporated
407	ClearWorks.net, Incorporated
408	CMI Corporation
409	CMI Corporation
410	Computer Learning Centers, Incorporated
411	Covad Communications Group
412	Cover-All Technologies Incorporated
413	Cumulus Media Incorporated
414	Del Global Technologies Corporation
415	Delphi Financial Group, Incorporated
416	Detour Magazine, Incorporated
417	Dicom Imaging Systems, Incorporated
418	Digital Lava Incorporated
419	Discovery Laboratories, Incorporated
420	DocuCorp International
421	DT Industries, Incorporated
422	e.spire Communications, Incorporated
423	EA Engineering, Science, and Technology, Incorporated
424	ebix.com, Incorporated
425	ebix.com, Incorporated
426	EDAP TMS S.A.
427	eMagin Corporation
428	Environmental Power Corporation
429	Epicor Software Corporation
430	eSAT Incorporated
431	Exide Corporation
432	FFW Corporation
433	FinancialWeb.com, Incorporated
434	First American Financial Corporation
435	First American Health Concepts, Incorporated
436	First American Health Concepts, Incorporated
437	First Tennessee National Corporation
438	FLIR Systems, Incorporated
439	Flooring America, Incorporated
440	FOCUS Enhancements, Incorporated
441	Gadzoox Networks, Incorporated
442	Geographics, Incorporated

443	Geron Corporation
444	Global Med Technologies, Incorporated
445	Good Guys, Incorporated
446	Goody's Family Clothing, Incorporated
447	Goody's Family Clothing, Incorporated
448	Guess ?, Incorporated
449	Hamilton Bancorp
450	Harmonic Incorporated
451	Hastings Entertainment, Incorporated
452	Heartland Technology, Incorporated
453	Hirsch International Corporation
454	Host Marriott Corporation
455	IBP, Incorporated
456	Image Sensing Systems, Incorporated
457	Imperial Credit Industries
458	Inacom Corporation
459	Indus International, Incorporated
460	Industrial Holdings, Incorporated
461	Information Management Associates, Incorporated
462	Innovative Gaming Corporation
463	Interiors, Incorporated
464	International Total Services, Incorporated
465	Internet America, Incorporated
466	Interplay Entertainment Corporation
467	Interspeed, Incorporated
468	Intimate Brands, Incorporated
469	Intrenet, Incorporated
470	J. C. Penney Company, Incorporated
471	JDN Realty Corporation
472	Jenna Lane, Incorporated
473	Kitty Hawk Incorporated
474	Kmart Corporation
475	Laidlaw Incorporated
476	LanguageWare.net Limited
477	Legato Systems, Incorporated
478	Lernout & Hauspie Speech Products N.V.
479	Lodgian, Incorporated
480	Louis Dreyfus Natural Gas Corporation

481	Lucent Technologies, Incorporated
482	Magellan Health Services, Incorporated
483	Magna International Incorporated
484	Master Graphics, Incorporated
485	MAX Internet Communications Incorporated
486	Mediconsult.com, Incorporated
487	Mercator Software, Incorporated
488	MerchantOnline.com, Incorporated
489	MetaCreations Corporation
490	MicroStrategy Incorporated
491	Mikohn Gaming Corporation
492	Mitek Systems, Incorporated
493	MITY Enterprises Incorporated
494	Monarch Investment Properties, Incorporated
495	National Fuel Gas Company
496	Network Systems International, Incorporated
497	Northeast Indiana Bancorp
498	Northpoint Communications Group
499	Nx Networks, Incorporated
500	Oil-Dri Corporation of America
501	Omega Worldwide Incorporated
502	Omni Nutraceuticals, Incorporated
503	OnHealth Network Company
504	On-Point Technology Systems Incorporated
505	Orbital Sciences Corporation
506	Oriental Financial Group Incorporated
507	Pacific Bank
508	Pacific Gateway Exchange, Incorporated
509	Parexel International Corporation
510	Paulson Capital Corporation
511	Phoenix International, Incorporated
512	Plains All American Pipeline, L.P.
513	Plains Resources Incorporated
514	Planet411.com Incorporated
515	Potlatch Corporation
516	Precept Business Service, Incorporated
517	Profit Recovery Group International, Incorporated
518	Pulaski Financial Corporation

519 Quintus Corporation
520 Ramp Networks, Incorporated
521 RAVISENT Technologies Incorporated
522 Raytheon Corporation
523 Rentrak Corporation
524 Rent-Way, Incorporated
525 RFS Hotel Investors, Incorporated
526 Roanoke Electric Steel Corporation
527 Safety Kleen Corporation
528 SatCon Technology Corporation
529 Scan-Optics, Incorporated
530 SCB Computer Technology, Incorporated
531 Seaboard Corporation
532 Segue Software, Incorporated
533 Serologicals Corporation
534 Shuffle Master, Incorporated
535 Source Media, Incorporated
536 Southwall Technologies, Incorporated
537 Sport-Haley, Incorporated
538 Sterling Financial Corporation
539 Stryker Corporation
540 SunStar Healthcare, Incorporated
541 Superconductive Components, Incorporated
542 Sykes Enterprises, Incorporated
543 Sykes Enterprises, Incorporated
544 Taubman Centers, Incorporated
545 TeleHubLink Corporation
546 Telemonde, Incorporated
547 Telescan, Incorporated
548 Telxon Corporation
549 The Limited, Incorporated
550 Thomas & Betts Corporation
551 TJX Companies, Incorporated
552 Today's Man, Incorporated
553 Too, Incorporated
554 Transport Corporation of America, Incorporated
555 Travel Dynamics Incorporated
556 TREEV, Incorporated

557 Tyco International Limited
558 UICI
559 Ultimate Electronics, Incorporated
560 Unify Corporation
561 Vari-L Company, Incorporated
562 Vari-L Company, Incorporated
563 Vertex Industries, Incorporated
564 W.R. Grace & Company
565 Westmark Group Holdings, Incorporated
566 Whitney Information Network, Incorporated
567 Winnebago Industries, Incorporated
568 WorldWide Web NetworX Corporation
569 Wyant Corporation

2001

570 Accelerated Networks, Incorporated
571 The Ackerley Group, Incorporated
572 Actuant Corporation
573 Adaptive Broadband Corporation
574 Advanced Remote Communication Solutions Incorporated
575 Air Canada Incorporated
576 Alcoa Incorporated
577 ALZA Corporation
578 AMC Entertainment, Incorporated
579 American HomePatient, Incorporated
580 American Physicians Service Group, Incorporated
581 Anchor Gaming
582 Andrew Corporation
583 Angiotech Pharmaceuticals, Incorporated
584 Anika Therapeutics Incorporated
585 Applied Materials, Incorporated
586 Argosy Education Group, Incorporated
587 ARI Network Services, Incorporated
588 Aronex Pharmaceuticals, Incorporated
589 Atchison Casting Corporation
590 Aviron
591 Avnet, Incorporated

592	Avon Products, Incorporated
593	BakBone Software Incorporated
594	Baldor Electric Company
595	Banner Corporation
596	Beyond.com Corporation
597	Brightpoint, Incorporated
598	BroadVision, Incorporated
599	Bull Run Corporation
600	California Amplifier, Incorporated
601	Cambior Incorporated
602	Campbell Soup Company
603	Cantel Medical Corporation
604	Cardiac Pathways Corporation
605	Cardiac Pathways Corporation
606	CellStar Corporation
607	CellStar Corporation
608	Centennial Communications Corporation
609	Centex Construction Products, Incorporated
610	Centex Corporation
611	Century Business Services, Incorporated
612	Charming Shoppes, Incorporated
613	Cheap Tickets, Incorporated
614	Checkpoint Systems, Incorporated
615	Chromaline Corporation
616	Chronimed, Incorporated
617	Cincinnati Financial Corporation
618	Clorox Company
619	Cohesion Technologies, Incorporated
620	Cohu, Incorporated
621	Commtouch Software Limited
622	ConAgra Foods, Incorporated
623	Concord Camera Corporation
624	Corel Corporation
625	Corixa Corporation
626	Credence Systems Corporation
627	Critical Path, Incorporated
628	Cyber Merchants Exchange, Incorporated
629	Daw Technologies, Incorporated

630	Dean Foods Company
631	Derma Sciences, Incorporated
632	Dial-Thru International Corporation
633	Digital Insight Corporation
634	Dillard's, Incorporated
635	Dollar General Corporation
636	Donnelly Corporation
637	ECI Telecom Limited
638	ECI Telecom Limited
639	EGames, Incorporated
640	Embrex Incorporated
641	Encad Incorporated
642	Energy West, Incorporated
643	Enron Corporation
644	ESPS, Incorporated
645	FindWhat.com
646	First Data Corporation
647	Fleming Companies, Incorporated
648	FLIR Systems, Incorporated
649	Fortune Brands, Incorporated
650	FreeMarkets, Incorporated
651	Gateway, Incorporated
652	GATX Corporation
653	Genentech, Incorporated
654	Greka Energy Corporation
655	Guardian International, Incorporated
656	Guess ?, Incorporated
657	HALO Industries Incorporated
658	Hamilton Bancorp
659	Hanover Compressor Company
660	Harrah's Entertainment Incorporated
661	Harrah's Entertainment Incorporated
662	Hayes Lemmerz International, Incorporated
663	Health Care Property Investors, Incorporated
664	Health Grades, Incorporated
665	Health Risk Management, Incorporated
666	Hemispherx Biopharma, Incorporated
667	Herman Miller, Incorporated

668	Hewlett-Packard Company
669	High Speed Net Solutions, Incorporated
670	Hollywood Casino Corporation
671	Homestake Mining Company
672	Homestore.com, Incorporated
673	IBP, Incorporated
674	ICNB Financial Corporation
675	IDEC Pharmaceuticals Corporation
676	IMAX Corporation
677	Immune Response Corporation
678	Industrial Distribution Group, Incorporated
679	Integrated Measurement Systems, Incorporated
680	Israel Land Development Company
681	J Jill Group, Incorporated
682	JDS Uniphase Corporation
683	Jones Lang LaSalle Incorporated
684	Kaneb Services, Incorporated
685	KCS Energy, Incorporated
686	Kennametal Incorporated
687	Kindred Healthcare, Incorporated
688	Krispy Kreme Doughnuts, Incorporated
689	Kroger Company
690	Lafarge North America Incorporated
691	Laidlaw Incorporated
692	Lancaster Colony Corporation
693	Lance Incorporated
694	Landec Corporation
695	Lands' End, Incorporated
696	Lason Incorporated
697	Learn2, Incorporated
698	LeCroy Corporation
699	Ledger Capital Corporation
700	Lions Gate Entertainment Corporation
701	LoJack Corporation
702	Lucent Technologies Incorporated
703	Lufkin Industries, Incorporated
704	Magna International Incorporated
705	Manitowoc Company, Incorporated

706 Marlton Technologies, Incorporated
707 MasTec Incorporated
708 MCK Communications, Incorporated
709 MERANT PLC
710 META Group Incorporated
711 Method Products Corporation
712 Midland Company
713 Minuteman International, Incorporated
714 Monsanto Company
715 Motor Club of America
716 National Commerce Financial Corporation
717 National Steel Corporation
718 NCI Building Systems, Incorporated
719 NESCO, Incorporated
720 Net4Music Incorporated
721 NetEase.com, Incorporated
722 New England Business Service, Incorporated
723 NexPub, Incorporated
724 NextPath Technologies, Incorporated
725 Nice Systems Limited
726 Northrop Grumman Corporation
727 NPS Pharmaceuticals, Incorporated
728 Online Resources Corporation
729 Onyx Software Corporation
730 Opal Technologies, Incorporated
731 Orthodontic Centers of America, Incorporated
732 Parallel Petroleum Corporation
733 Paulson Capital Corporation
734 Pennzoil-Quaker State Company
735 Pinnacle Holdings, Incorporated
736 Placer Dome Incorporated
737 PlanetCAD, Incorporated
738 Pre-Paid Legal Services, Incorporated
739 Pre-Paid Legal Services, Incorporated
740 Private Media Group, Incorporated
741 Provident Bankshares
742 Proxim, Incorporated
743 PurchasePro.com, Incorporated

744	PXRE Group Limited
745	Rare Medium Group, Incorporated
746	Rayovac Corporation
747	Reader's Digest Association, Incorporated
748	Reynolds and Reynolds Company
749	Riviana Foods Incorporated
750	Roadhouse Grill, Incorporated
751	Robotic Vision Systems, Incorporated
752	Rock-Tenn Company
753	SCB Computer Technology, Incorporated
754	SeaView Video Technology, Incorporated
755	Semitool, Incorporated
756	Service Corporation International
757	Shurgard Storage Centers, Incorporated
758	Sonus Corporation
759	Sony Corporation
760	Southern Union Company
761	Southwest Securities Group, Incorporated
762	SRI/Surgical Express, Incorporated
763	StarMedia Network, Incorporated
764	Stolt-Nielsen S.A.
765	Sykes Enterprises, Incorporated
766	Take-Two Interactive Incorporated
767	Team Communications Group, Incorporated
768	TeleCorp PCS, Incorporated
769	Toro Company
770	Trikon Technologies, Incorporated
771	True North Communications Incorporated
772	Tyco International Limited
773	U.S. Aggregates, Incorporated
774	U.S. Wireless Corporation
775	Unify Corporation
776	Urban Outfitters, Incorporated
777	UTStarcom, Incorporated
778	Vans, Incorporated
779	Varian, Incorporated
780	VIA NET.WORKS, Incorporated
781	Vical Incorporated

782 Vicon Fiber Optics Corporation
783 Wackenhut Corporation
784 Wackenhut Corporation
785 Wallace Computer Services, Incorporated
786 Warnaco Group, Incorporated
787 Warnaco Group, Incorporated
788 Webb Interactive Services, Incorporated
789 Western Digital Corporation
790 Westfield America, Incorporated
791 Westvaco Corporation
792 Williams Controls, Incorporated
793 Woodhead Industries, Incorporated
794 Xerox Corporation

2002

795 ACTV, Incorporated
796 Adelphia Communications Corporation
797 Advanced Magnetics, Incorporated
798 Advanced Remote Communication Solutions Incorporated
799 Akorn Incorporated
800 Alliant Energy Corporation
801 Allied Irish Banks PLC
802 Almost Family, Incorporated
803 American Physicians Service Group, Incorporated
804 Anadarko Petroleum Corporation
805 Avanex Corporation
806 AvantGo, Incorporated
807 Avista Corporation
808 Baltimore Technologies PLC
809 Barrett Business Services, Incorporated
810 BroadVision, Incorporated
811 Calpine Corporation
812 CIT Group Incorporated
813 CMS Energy Corporation
814 Cognos, Incorporated
815 Collins & Aikman Corporation
816 Computer Associates International, Incorporated

817	Cornell Companies
818	Corrpro Companies, Incorporated
819	Cost-U-Less, Incorporated
820	Creo Incorporated
821	Del Global Technologies Corporation
822	Del Monte Foods Company
823	Dillard's, Incorporated
824	DOV Pharmaceutical, Incorporated
825	Dover Corporation
826	Drexler Technology Corporation
827	DuPont Company
828	Eagle Building Technologies, Incorporated
829	eDiets.com, Incorporated
830	Edison Schools Incorporated
831	eFunds Corporation
832	Eidos PLC
833	Enterasys Network, Incorporated
834	EOTT Energy Partners, L.P.
835	Escalon Medical Corporation
836	Exelon Corporation
837	FFP Marketing Company, Incorporated
838	FiberNet Telecom Group, Incorporated
839	Fields Technologies, Incorporated
840	Flagstar Bancorp, Incorporated
841	FloridaFirst Bancorp, Incorporated
842	Flow International Corporation
843	Foamex International
844	Foster Wheeler Limited
845	Gemstar-TV Guide International, Incorporated
846	GenCorp Incorporated
847	Gerber Scientific, Incorporated
848	Great Pee Dee Bancorp, Incorporated
849	Haemonetics Corporation
850	Hanover Compressor Company
851	Hanover Compressor Company
852	Hometown Auto Retailers Incorporated
853	HPSC, Incorporated
854	Hub Group, Incorporated

855 I/Omagic Corporation
856 iGo Corporation
857 ImmunoGen, Incorporated
858 Imperial Tobacco Group PLC
859 Input/Output, Incorporated
860 JNI Corporation
861 Key Production Company, Incorporated
862 Kmart Corporation
863 Kraft Foods Incorporated
864 L90, Incorporated
865 Lantronix, Incorporated
866 Measurement Specialties, Incorporated
867 Medis Technologies, Limited
868 Metromedia Fiber Network, Incorporated
869 Minuteman International, Incorporated
870 Monsanto Company
871 Network Associates, Incorporated
872 Northwest Bancorp, Incorporated
873 NuWay Energy Incorporated
874 NVIDIA Corporation
875 Omega Protein Corporation
876 OneSource Technologies, Incorporated
877 PAB Bankshares Incorporated
878 Pennzoil-Quaker State Company
879 Peregrine Systems, Incorporated
880 Peregrine Systems, Incorporated
881 Performance Food Group Company
882 Petroleum Geo-Services ASA
883 PG&E Corporation
884 Pharamaceutical Resources, Incorporated
885 Phar-Mor, Incorporated
886 Phillips Petroleum Company
887 Photon Dynamics, Incorporated
888 The PNC Financial Services Group, Incorporated
889 The PNC Financial Services Group, Incorporated
890 Pyramid Breweries Incorporated
891 Qiao Xing Universal Telephone, Incorporated
892 Raining Data Corporation

893	Reliant Energy, Incorporated
894	Reliant Resources, Incorporated
895	Reliant Resources, Incorporated
896	Restoration Hardware, Incorporated
897	Rotonics Manufacturing Incorporated
898	SeaView Video Technology, Incorporated
899	Seitel, Incorporated
900	Smart & Final Incorporated
901	Standard Commerical Corporation
902	Star Buffet, Incorporated
903	Stratus Properties Incorporated
904	Superior Financial Corporation
905	Supervalu Incorporated
906	Sybron Dental Specialties, Incorporated
907	The Hain Celestial Group, Incorporated
908	Transmation, Incorporated
909	United Pan-Europe Communications N.V.
910	United States Lime & Minerals, Incorporated
911	Univision Communications Incorporated
912	USABancShares.com, Incorporated
913	Vail Resorts, Incorporated
914	Viad Corporation
915	Williams-Sonoma Incorporated
916	WorldCom, Incorporated
917	Xerox Corporation
918	Xplore Technologies Corporation
919	Zapata Corporation

Source: GAO staff analysis of various documents.

Case Study Overview

Our objective in reviewing individual restatements was to provide detailed information on selected areas for 16 companies.[101] The purpose of this appendix is to explain how each case study is structured and what information is being provided. Specifically, each of the cases discussed in appendixes V through XX provides information on (1) the company's operations; (2) the chronology of the restatement, including who initiated the restatement; (3) the company's independent auditor; (4) the market's reaction to the restatement; (5) securities analysts' recommendations; (6) the relevant credit ratings of the company's debts; and (7) legal and/or regulatory actions taken against the company, its executives, directors, independent auditors or others. The 16 companies are listed in table 8.

Table 8: Case Studies

Appendix	Company
V	Adelphia Communications Corporation
VI	Aurora Foods Inc.
VII	Critical Path, Inc.
VIII	Enron Corporation
IX	Hayes Lemmerz International, Inc.
X	JDS Uniphase Corporation
XI	MicroStrategy Incorporated
XII	Orbital Sciences Corporation
XIII	Rite Aid Corporation
XIV	Safety-Kleen Corporation
XV	SeaView Video Technology, Inc.
XVI	Shurgard Storage Centers, Inc.
XVII	Sunbeam Corporation
XVIII	Thomas & Betts Corporation
XIX	Waste Management, Inc.
XX	Xerox Corporation

Source: GAO.

[101]For an explanation of how we selected the 16 companies, see appendix I (Objectives, Scope and Methodology).

Our analysis was based on only publicly available information, including company press releases and filings with the Securities and Exchange Commission (SEC) (for example, Forms 10-K, 10-Q, and 8-K); SEC press releases, complaints, and settlement agreements; public Department of Justice documents; analysts' recommendations; credit agency ratings; historical company rating information maintained by research sources; newspaper articles; and congressional testimonies. Although we did not interview the company officials to obtain information about the restatements, we requested comments on the case studies from each of the 16 companies and incorporated any technical comments received, as appropriate.

Business Overview

Each case begins with an overview of the business in which the company engages and generally provides information on its size (total revenue) and number of employees.

Restatement Data

Each of the companies restated its financial statements at least once from 1997 to 2002, and this section discusses the nature of the misstated information and the resulting restatement decision by the company's management. We also included previously reported or announced financial results and the revised or restated financial data for selected information such as revenue and net income (losses). Finally, we also identified those companies that announced a restatement but have not yet filed restated financial statements with SEC.

Accounting/Auditing Firm

This section provides information on the independent auditor of record during the restatement period and whether the restating company changed its auditor before, during, or after the restatement. We also provide information on civil and criminal actions taken against the auditors.

Stock Prices

To illustrate the impact of a restatement announcement on a company's stock price, we provide selected historical closing stock price information for each company. We also discuss how stock prices were impacted in the days surrounding the restatement announcement and discuss other events that may have positively or adversely impacted the company's stock price. In many of the cases, the company had lost a significant amount of its stock

value before the restatement announcement. Often it had already missed an earnings target or announced an internal investigation.

Securities Analysts' Recommendations

Given the criticism that many securities analysts have faced about their optimistic ratings of companies in the face of adverse financial results and condition, we were asked to focus on the role played by analysts in recommending securities. Therefore, in this section we provide historical information on securities analysts' ratings in the months leading up to and after financial statement restatements and other announcements about the financial condition of the covered (researched) company. We found no single authoritative source for historical analyst recommendations and relied on a variety of sources for this data such as *Yahoo!Finance* and *CNET Investor*.

Analysts use different rating systems and a variety of terms, including strong buy, buy, near-term or long-term accumulate, near-term or long-term over-perform or under-perform, neutral, hold, reduce, sell, and strong sell. Critics often point to the large disparity between analysts' buy recommendations and sell recommendations (the latter made up less than 2 percent in 2000). However, the terms have been criticized as being misleading because "hold" may mean that investors should sell the stock versus holding it. Although we do not attempt to determine the definition of each term for each firm, we provide the recommendations because they illustrate the range of rating systems that analysts use. We generally focused on changes in ratings around certain key dates to provide some indication of what signals analysts were sending to the markets.

Credit Rating Agency Actions Taken

Like analysts, credit rating agencies have been questioned about the quality of the information they provide, and this scrutiny heightened after the rapid failure of Enron. To determine the information credit rating agencies were providing to the market about the condition of these companies, we collected credit rating information on companies when such information was available. Once again we focused on changes in ratings around certain key dates, such as the restatement announcement date, the actual restatement date, and announcements of internal investigations, and bankruptcy filings.

Legal and Regulatory Actions Taken

To determine the legal and regulatory actions taken, we searched for evidence of any lawsuits and whether SEC and or the Department of Justice had taken any action in connection with the restatement of a company's financial results. We found that many of the cases led to shareholder lawsuits and that SEC and in some cases the Department of Justice had taken action against the company, its officials, and its independent auditor.

Adelphia Communications Corporation

Business Overview

Adelphia Communications Corporation (Adelphia) provides entertainment and communication services, including high-speed Internet services, cable entertainment, digital cable, long distance telephone services, home security, and messaging. Telecommunications services and equipment accounted for 77 percent of 2000 revenues; advertising and other services, 14 percent; and premium programming, 9 percent.

In June 2002, Adelphia and more than 200 of its subsidiaries and partnerships and joint ventures in which it holds at least 50 percent ownership interest filed for Chapter 11 bankruptcy protection under the federal bankruptcy code.

Restatement Data

On March 27, 2002, Adelphia announced its fourth quarter and 2001 results of operations, which included for the first time, the existence of certain previously unreported off-balance sheet liabilities. According to company and Securities and Exchange Commission (SEC or Commission) documents, in March 2002, Adelphia's board of directors appointed a Special Committee of Independent Directors (Special Committee) to review business relationships between the company and certain affiliates. As part of that review, the Special Committee identified accounting and disclosure issues, some of which raised questions about whether the company's management had engaged in improper activities. Based on the preliminary results of the investigation, management of the company decided to make certain adjustments to (1) its results of operations for 2000 and 2001, (2) its guidance with respect to management's earnings expectations for 2002, and (3) certain previous public statements regarding the number of subscribers to the company's cable television systems.

On May 2, 2002, Adelphia announced that it had reached a tentative conclusion regarding the accounting treatment of certain "co-borrowing" agreements, which Adelphia expects to result in the restatement of its previously issued financial statements for 1999, 2000, and interim financial statements for 2001 (table 9). The tentative conclusions are subject to the completion of its annual audit. However, the company estimated that the restatement would increase by about $2.6 billion, as of December 31, 2001, to reflect the full amount of principal borrowings by certain co-borrowing arrangements for which subsidiaries of the company are jointly and severally liable.

Table 9: Selected Financial Data, 1999–2001

Dollars in millions

Affected financial data	Fiscal year 1999	Fiscal year 2000	Fiscal year 2001
Consolidated revenues, as reported	$1,288	$2,608	$3,580
Consolidated revenues, estimated restatement	N/A	2,548	3,510
EBITDA, as reported	Unavailable	1,202	1,409
EBITDA, estimated restatement	N/A	1,042	1,199

Note1: EBITDA means earnings before interest, taxes, depreciation, and amortization. To date, Adelphia has not filed its 2001 Form 10-K or amended Form 10-Ks for 1999 or 2000.

Note2: N/A means not applicable.

Source: SEC filings.

Current management took control in May 2002 and has retained new independent auditors and begun the preparation of new financial statements. According to Adelphia's August 20, 2002, amended Form 8-K filed with SEC, the company has not filed its quarterly or annual filings with SEC but still expects to restate its financial statements for the years ended December 31, 1999, and 2000, and its interim financial statements for 2001 and possibly other periods. In addition, current management believes that the public information provided by prior management on other matters of interest to investors, such as the percentage of the company's cable television systems that the company believes have been upgraded to current standards, was unreliable. As a result, the company anticipates that it may have to supplement the financial and certain other information and that such supplemental information may be material.

Accounting/Audit Firm

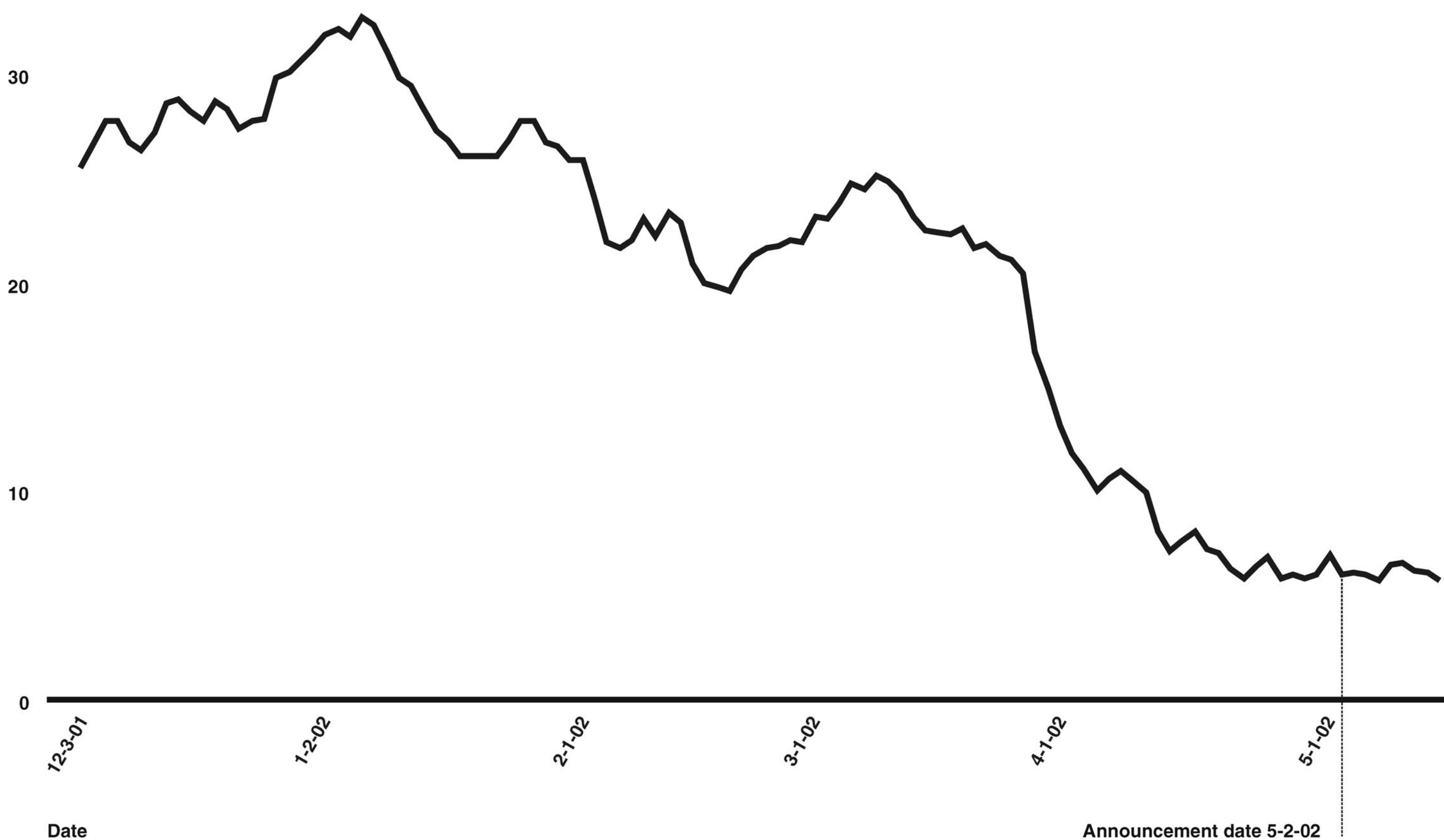
Deloitte & Touche LLP (Deloitte) was the independent auditor during the relevant period. According to Adelphia's filing with SEC, on May 14, 2002, Deloitte advised Adelphia that it had suspended its audit of the financial statements of the company for the year ended December 31, 2001. According to Adelphia's Form 8-K (amendment no. 3), Deloitte's 1999 and 2000 reports on Adelphia's financial statements contained no adverse opinion or disclaimer of opinion and were not qualified or modified as to uncertainty, audit scope or accounting principles. However, according to SEC's complaint against Adelphia and certain individuals, Deloitte had

advised Adelphia to disclose the existence of several off-balance-sheet liabilities in a footnote disclosure but relented when management did not accept the advice. On June 9, 2002, Adelphia terminated Deloitte as its independent auditor. On June 13, 2002, the company retained PricewaterhouseCoopers LLP (PwC) as its new independent accountant. As of August 20, 2002, PwC was still in the process of completing its audit of Adelphia.

Stock Price

The company's common stock was traded on the National Association of Securities Dealers Automated Quotation (Nasdaq) under the ticker symbol ADLAC. On April 18, 2002, Adelphia announced that it received a Nasdaq Staff Determination Letter on April 17, 2002, indicating that it did not comply with Marketplace Rule 4310(c)(14) for failing to timely file with the SEC its annual report on Form 10-K for the year ended December 31, 2001. Accordingly, its securities were subject to delisting from the Nasdaq Stock Market. Nasdaq suspended trading in Adelphia's shares on May 14, 2002, and subsequently delisted Adelphia's stock on June 3, 2002. The company now trades over-the-counter under the ticker symbol ADELQ. Although we were unable to compile comprehensive daily stock price information for Adelphia after trading in its stock was suspended on Nasdaq, we found in the days surrounding Adelphia's March 26, 2002, announcement of its fourth quarter and year end 2001 results, which included previously unreported off-balance sheet liabilities, the price of Adelphia's stock fell over 20 percent from a closing price of $20.39 per share before the announcement to $14.90 the day after the announcement (fig.12). It stock continued to trend downward in April and by May 1, 2002, the day before Adelphia announced that it would likely restate its financial statements for 2000 and 2001, its stock price fell almost 13 percent from $6.95 the day before to $6.05 the day after.

Figure 12: Daily Stock Prices for Adelphia, December 1, 2001–May 14, 2002



Source: GAO's analysis of New York Stock Exchange Trade and Quote data.

Securities Analysts' Recommendations

Based on historically available securities analysts' recommendations we were able to identify around the time of Adelphia's restatement announcement and discovery of widespread problems, we found information on three firms that researched the company. All three firms lowered their recommendations during May 2002 following Adelphia's announcement of restatement and tentative restated results. Only one of

the three recommended avoiding the stock, another recommended holding it, and the last firm rated Adelphia as underweight.

Credit Rating Agency Actions

Adelphia's debt is rated by Moody's Investors Service, Inc. (Moody's) and Standard and Poor's. On January 22, 2002, Moody's announced that it had concluded its review of Adelphia and confirmed its bond ratings, and rated the company's outlook as stable. On March 27, 2002, the day Adelphia announced its 2001 results, which included information on off-balance sheet debt that had not previously been reported, Moody's announced that it had initiated a review of Adelphia and that its ratings remained under review for a possible downgrade. On April 8, and again on April 22, 2002, Standard and Poor's downgraded Adelphia's debt. On May 6, 2002, following its announcement of changes in certain accounting practices and the likely restatement of its 1999, 2000, and interim 2001 financial reports, Moody's downgraded Adelphia's ratings and stated that they remained under review for further downgrade. On May 15, 2002, the date Adelphia announced that it had failed to make interest payments on outstanding debt securities and certain preferred stock, Moody's and Standard and Poor's downgraded Adelphia further and Moody's kept it under review for possible additional downgrades. On May 20, 2002, Standard and Poor's downgraded the debt even further, indicating that Adelphia had failed to pay at least one or more of its financial obligations when it came due. On June 5, 2002, Moody's issued an opinion update and adjusted its ratings of Adelphia to reflect recovery values pending the expected bankruptcy filing, which was subsequently filed on June 25.

Legal and Regulatory Actions Taken

More than two dozen shareholder class-action lawsuits have been filed against Adelphia, alleging that the Rigas family violated Section 10(b) and 20(a) of the Securities Exchange Act of 1934 (Exchange Act), by issuing materially false and misleading statements and omitting material information regarding the company and its business operations. For example, as alleged in the complaint, defendants concealed borrowings, understated the company's debt levels, and failed to adequately disclose the existence of billions of dollars of off-balance sheet debt.

On June 24, 2002, Adelphia announced that it had filed suit against John Rigas, the Company's founder and former chairman; his sons—Tim, Michael, and James Rigas—who are former board members and company executives; Peter Venetis his son-in-law, who was a member of the board at

the company; James Brown, former vice president of finance, and Michael Mulcahey, former assistant treasurer. Also named in the lawsuit were Doris Rigas, wife of John Rigas; Ellen Rigas Venetis, daughter of John Rigas; and 20 companies controlled by the family. The lawsuit charges the defendants with violation of the Racketeer Influenced and Corrupt Organizations (RICO) Act, breach of fiduciary duties, waste of corporate assets, abuse of control, breach of contract, unjust enrichment, fraudulent conveyance, and conversion of corporate assets.

On June 25, 2002, Adelphia and more than 200 of its subsidiaries and partnerships and joint ventures in which it holds at least 50 percent ownership interest collectively filed voluntary petitions under Chapter 11 of the U.S. Bankruptcy Code with the U.S. Bankruptcy Court for the Southern District of New York.[102]

On July 24, 2002, SEC filed suit in the U.S. District Court for the Southern District of New York charging Adelphia and several individuals "in one of the most extensive financial frauds ever to take place at a public company." The complaint alleges that between mid-1999 and the end of 2001, Adelphia fraudulently excluded from its annual and quarterly consolidated financial statements over $2 billion in debt by systematically recording those liabilities on the books of unconsolidated affiliates, which violated generally accepted accounting principles (GAAP).

SEC charges that:

> Adelphia, at the direction of the individual defendants: (1) fraudulently excluded billions of dollars in liabilities from its consolidated financial statements by hiding them in off-balance sheet affiliates; (2) falsified operation statistics and inflated Adelphia's earnings to meet Wall Street's expectations; and (3) concealed rampant self-dealing by the Rigas family, including the undisclosed use of corporate funds for Rigas family stock purchases and the acquisition of luxury condominiums in New York and elsewhere. Section 17(a) of the Securities Act of 1933 (Securities Act), 15 U.S.C. § 77q(a), Sections 10(b), 13(a), 13(b)(2)(A) and 13(b)(2)(B) of the Exchange Act, 15 U.S.C. §§ 78j(b), 78m(a),

[102]Pursuant to the automatic stay provisions of Section 362 of the Federal Bankruptcy Code, 11 U.S.C. § 362, actions to collect pre-petition indebtedness and virtually all litigation against the debtor that was or could have been brought prior to commencement of a Chapter 11 bankruptcy proceeding are stayed unless the stay is lifted by the court.

78m(b)(2)(A) and 78m(b)(2)(B), and Rules 10b-5, 12b-20, 13a-1, and 13a-13, 17 C.F.R. §§ 240.10b-5, 240.12b-20, 240.13a-1, and 240.13a-13.

In addition to Adelphia, the complaint charges several individuals with numerous securities law violations. Specifically, the Commission's complaint alleges as follows:

- Between mid-1999 and the end of 2001, John J. Rigas, the founder, chief executive officer, and chairman of the board until May 15, 2002; Timothy J. Rigas, chief financial officer, chief accounting officer, treasurer, and board director until May 16, 2002; Michael J. Rigas, executive vice president for operations and secretary until May 23, 2002; James P. Rigas, vice president for strategic planning until May 23, 2002; and James R. Brown, vice president of finance until May 19, 2002; with the assistance of Michael C. Mulcahey, vice president and assistant treasurer, caused Adelphia to fraudulently exclude from the company's annual and quarterly consolidated financial statements over $2.3 billion in bank debt by deliberately shifting those liabilities onto the books of Adelphia's off-balance sheet, unconsolidated affiliates. Failure to record this debt violated GAAP requirements and laid the foundation for a series of misrepresentations about those liabilities by Adelphia and the defendants, including the creation of (1) sham transactions backed by fictitious documents to give the false appearance that Adelphia had actually repaid debts when, in truth, it had simply shifted them to unconsolidated Rigas-controlled entities and (2) misleading financial statements by giving the false impression through the use of footnotes that liabilities listed in the company's financials included all outstanding bank debt.

- Timothy J. Rigas, Michael J. Rigas, and James R. Brown made repeated misstatements in press releases, earnings reports, and Commission filings about Adelphia's performance in the cable industry, by inflating (1) Adelphia's basic cable subscriber numbers; (2) the extent of Adelphia's cable plant "rebuild" or upgrade; and (3) Adelphia's earnings, including its net income and quarterly EBTIDA. Each of these represents key "metrics" by which Wall Street evaluates cable companies.

- Since at least 1998, Adelphia, through the Rigas family and Mr. Brown, made fraudulent misrepresentations and omissions of material fact to conceal extensive self-dealing by the Rigas family. Such self-dealing included the use of Adelphia funds to finance undisclosed open market

stock purchases by the Rigas family, purchase timber rights to land in Pennsylvania, construct a golf club for $12.8 million, pay off personal margin loans and other Rigas family debts, and purchase luxury condominiums in Colorado, Mexico, and New York City for the Rigas family.

The Commission alleges that the defendants continued their fraud even after Adelphia acknowledged, on March 27, 2002, that it had excluded several billion dollars in liabilities from its balance sheet. The defendants allegedly covered-up their conduct and secretly diverted $174 million in Adelphia funds to pay personal margin loans of Rigas family members.

SEC seeks a final judgment ordering the defendants to account for and disgorge all ill-gotten gains including all compensation received during the fraud, all property unlawfully taken from Adelphia through undisclosed related-party transactions, and any severance payments related to their resignations from Adelphia. SEC also seeks civil penalties from each defendant; and further, SEC seeks an order barring each of the individual defendants from acting as an officer or director of a public company.

In conjunction with these civil charges, John Rigas, Timothy Rigas, and Michael Rigas were arrested on federal criminal charges of conspiracy and securities fraud, wire fraud, and bank fraud. Mr. Brown, Adelphia's former vice president of finance and Mr. Mulcahy, the former director of internal reporting, were also arrested on the same charges. All five were indicted by a federal grand jury on September 23, 2002. According to press reports, prosecutors may file charges against other former Adelphia officials.

Aurora Foods Inc.

Business Overview

Aurora Foods Inc. (Aurora) is a producer and marketer of branded food. It was incorporated in 1998 as the successor to Aurora Foods Holdings, Inc., and its subsidiary AurFoods Operating Company, Inc. Aurora's brands include Duncan Hines, Mrs. Butterworth, Log Cabin, Van de Kamp's, Mrs. Paul's, Aunt Jemina, Celeste, Chef's Choice, and Lender's. Its brands are grouped into two general divisions: the dry grocery division and the frozen food division. As of December 31, 2001, the company had net sales of over $1 billion, and as of February 28, 2002, it had about 2,000 employees.

Restatement Data

During the end of year 1999 audit, Aurora's independent auditor, PricewaterhouseCoopers LLP (PwC), discovered documents that raised questions about the company's accounting practices and informed the audit committee of the board of directors of its findings on February 9, 2000. Two days later, Aurora's board of directors, after discussion with its auditors, formed a special committee to conduct an investigation into the company's application of certain accounting policies. The special committee retained legal counsel (Ropes & Gray), which hired an independent accounting firm (Deloitte & Touche LLP) to assist in the investigation. Through its investigation, the independent auditor determined that liabilities that existed for certain trade promotion and marketing activities and other expenses (primarily sales returns and allowances, distribution and consumer marketing) were not properly recognized as liabilities and that certain assets were overstated (primarily accounts receivable, inventories, and fixed assets). On February 17, 2000, several members of senior management resigned including the chairman and chief executive officer (CEO), the vice chairman, and chief financial officer (CFO).

On April 3, 2000, Aurora announced restatements of earnings for 1999 and 1998. Specifically, previously reported pretax earnings would be reduced by $43.3 million for the first three quarters of 1999 and by $38.3 million for the third and fourth quarters of 1998 (table 10).

Table 10: Selected Financial Data, 1998-1999

Dollars in thousands

Affected financial data	Third quarter fiscal year 1998	Fourth quarter fiscal year 1998	First quarter fiscal year 1999	Second quarter fiscal year 1999	Third quarter fiscal year 1999
Pretax earnings, as reported	$12,235	$25,698	$12,942	$13,146	$18,045
Pretax earnings (loss), as restated	(4,831)	4,493	699	(5,404)	5,546

Source: SEC filings.

Aurora also announced the appointment of a new president and executive vice president, both of whom were to join the company's board of directors.

Accounting/Audit Firm

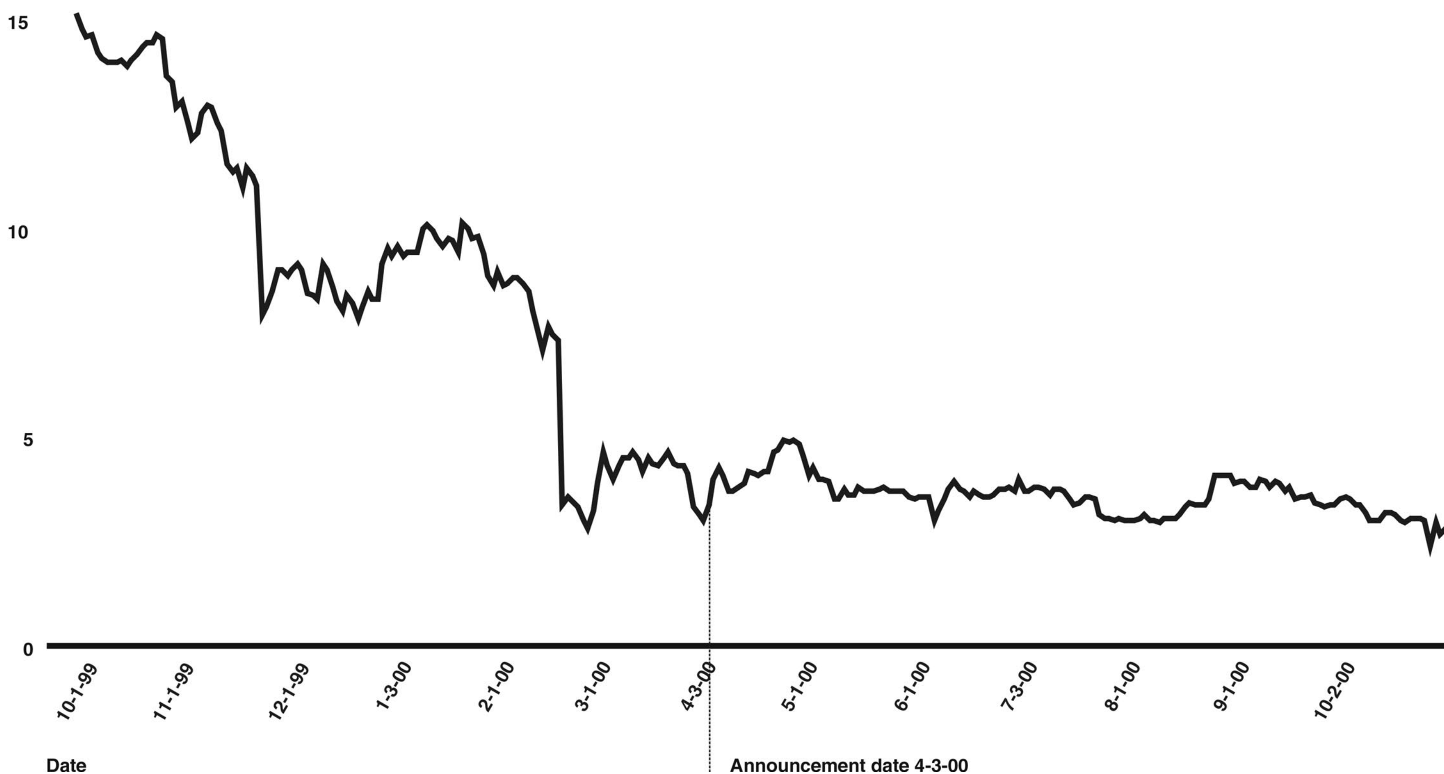
Aurora's independent auditor in 1999 was PwC, which audited Aurora's most recent annual financial statements to date.

Stock Price

Aurora's stock trades on the New York Stock Exchange (NYSE) under the ticker symbol AOR. Prior to its restatement, from November 22, 1999, to November 24, 1999, Aurora's stock price fell over 26 percent on the news that its fourth quarter earnings would be hurt by lower profits from one of its operations and higher interest expense. On February 1, 2000, Aurora's stock price closed at $8.94. In the days surrounding the February 11, 2000, creation of a special committee to conduct an investigation into the company's accounting practices, Aurora's stock price fell over 10 percent to $7.06. However, Aurora's stock fell over 50 percent from February 17 to February 22, 2000, following the announcement that it was investigating its financial practices and that several members of its senior management team had resigned. Aurora's stock price remained volatile and trended downward, closing at $3.00 on March 31, 2000 (see fig. 13). On April 3, 2000, the day that Aurora restated its financial statements, the stock price closed at $3.375, up over 12 percent. The stock price moved up over 18 percent on April 4 to close at $4.00 per share. Over the three trading days from March

31 through April 4, Aurora's stock price increased over 30 percent. The stock generally traded between $3 and $5 for the next several months.

Figure 13: Daily Stock Prices for Aurora, October 1, 1999—October 31, 2000



Source: GAO's analysis of NYSE Trade and Quote data.

Securities Analysts' Recommendations

Based on historical securities analyst recommendations that we were able to identify, we found historical analyst recommendations from four firms that covered Aurora. According to one publicly available history of analyst ratings, recommendations for Aurora varied from buy to market perform,

depending on the analyst. In November 1999, three firms downgraded their recommendations on the news that Aurora expected its fourth quarter results to be adversely impacted by certain operations and expenses. However, none of them recommended a sell. In February 2000, following news of a delay in filing its financial reports with the Securities and Exchange Commission (SEC or Commission) and the resignation of several members of senior management (over a month before the restatement announcement), one analyst upgraded his recommendation from market perform to buy, while another analyst downgraded his buy recommendation to a market perform.

Credit Rating Agency Actions

Aurora's debt is rated by Moody's Investors' Service, Inc. (Moody's). On April 3, 2000, the date of the restatement announcement, Aurora's corporate bond rating indicated that conditions may have existed that indicate the inability of the company to pay principal or interest on the obligations. This rating was confirmed in May 2000. On February 9, 2001, Moody's confirmed Aurora's rating for senior secured credit facility, a mid-range rating indicating that the company's obligations generally lack the characteristics of desirable investments. According to this rating, payment of principal and interest or maintenance of other contract terms over a long period was in doubt. Although at the higher end of the low-grade rating category, Aurora's senior subordinated note rating indicated that there potentially were conditions hampering the ability of the company to pay principal or interest on its obligations.

Legal and Regulatory Actions Taken

Aurora was subject to shareholder lawsuits and regulatory action related to its accounting practices. As of April 13, 2000, Aurora had been served with 13 complaints in class-action lawsuits in the U.S. District Court for the Northern District of California. The complaints alleged, among other things, that as a result of accounting irregularities, the company's previously issued financial statements were materially false and misleading and thus constituted violations of federal securities laws. The complaints sought damages in unspecified amounts and were brought on behalf of purchasers of the common stock during various periods, all of which fell between October 28, 1998, and February 18, 2000.

According to company filings, on January 16, 2001, Aurora reached a preliminary agreement to settle the securities class-action and derivative lawsuits pending against the company and its former management team.

Under the terms of the agreement, Aurora will pay the class members $26 million in cash and $10 million in common stock of the company. On March 2, 2001, the company entered into definitive agreements with certain members of former management to transfer to the company between approximately 3 million and 3.6 million shares of common stock of the company, in consideration for a resolution of any civil claims that the company may have had, and partially conditioned upon future events and circumstances. The cash component of the settlement was to be funded entirely by the company's insurance. As of March 23, 2001, with respect to the common stock component of the settlement, the stock received from former management would be sufficient, at current share prices, to satisfy Aurora's obligation without issuing additional shares. The actual number of shares of common stock of the company needed to fund this component was to be based on average share prices determined at later dates. However, members of the class have the opportunity to opt out of the settlement agreement, and bring separate claims against the company. In addition, the company has agreed to continue to implement certain remedial measures, including the adoption of an audit committee charter, the reorganization of the company's finance department, the establishment of an internal audit function and the institution of a compliance program, as consideration for resolution of the derivative litigation.

According to company filings within SEC, the staff of SEC and the U.S. Attorney for the Southern District of New York also initiated investigations relating to the events that resulted in the restatement of the company's financial statements for prior periods. SEC and the U.S. Attorney requested that the company provide certain documents relating to the company's historical financial statements. On September 5, 2000, the company received a subpoena from SEC to produce documents in connection with the restatements. SEC also requested certain information regarding some of the company's former officers and employees, correspondence with the company's auditors and documents related to financial statements, accounting policies, and certain transactions and business arrangements.

On January 23, 2001, the U.S. Attorney announced indictments alleging financial accounting fraud against members of former management and certain former employees of Aurora. Subsequently, three senior officials and one division official pled guilty to the charges. The U.S. Attorney did not bring charges against Aurora. In a cooperation agreement with the U.S. Attorney, Aurora confirmed that it would continue to implement an extensive compliance program, which will include an internal audit function, a corporate code of conduct, a comprehensive policies and

procedures manual, employee training and education on policies and procedures, and adequate disciplinary mechanisms for violations of policies and procedures. According to an Aurora official and various press reports, in 2002, Ms. Laurie Cummings, the former CFO, was sentenced to 57 months imprisonment. Other officials are scheduled to be sentenced later this year.

In addition, Aurora consented to the entry of an order by SEC requiring compliance with requirements for accurate and timely reporting of quarterly and annual financial results, and the maintenance of internal control procedures in connection with a civil action by SEC concerning accounting irregularities at the company in 1998 and 1999. Aurora neither admitted nor denied any wrongdoing, and SEC did not seek any monetary penalty. Aurora also committed to continue to cooperate with SEC in connection with its actions against certain former members of management and former employees.

According to SEC's January 23, 2001, press release, SEC also brought securities fraud charges against three former senior officers and four employees of Aurora, in connection with a scheme that caused Aurora to underreport trade marketing expenses and substantially inflate reported earnings in 1998 and 1999. In addition, another former employee was charged with corporate reporting and recordkeeping violations. SEC also announced that it had simultaneously settled the charges against two of the individuals.

The complaint alleges that Aurora's senior management, consisting of Ian R. Wilson, chairman of the board of directors and CEO of Aurora, from June 1998 until he resigned on February 17, 2000; Ms. Laurie Cummings, CFO of Aurora, from June 1998 until she resigned on February 17, 2000; and Ray Chung, executive vice president of Aurora, from June 1998 until he resigned on February 17, 2000, were aware that Aurora was not accurately reporting trade marketing expense, which is the expense Aurora incurs to induce grocery stores to purchase its products. (For example, a case discount or other similar incentive.) Instead of properly booking the expense, Mr. Wilson, Ms. Cummings, and Mr. Chung allegedly tried to conceal it from the auditors by directing division level officers and employees to make false entries in various accounts on the company's books. The effect was to falsely and substantially inflate the Aurora's financial results. The complaint states that the result was to materially understate expenses and liabilities on the company's publicly filed financial statements. The object of the scheme was to conceal from the investing

public the fact that the company had not met its earnings targets from quarter to quarter.

The scheme allegedly involved several other employees, including Dirk Grizzle, vice-president of finance and principal financial officer of Aurora's Foods division (AFI) until June 2000. The complaint described the following events. Sometime in March 1999, Mr. Grizzle and Ms. Cummings discussed putting known trade promotion expenses in accounts receivable, rather than simply recording them on Aurora's books. The effect would be to conceal these expenses from the auditors. Thereafter, on a regular basis, Ms. Cummings and/or Mr. Chung instructed Mr. Grizzle to move large portions of the expense to accounts receivable. Mr. Grizzle carried out these instructions by directing Tammy Fancelli, a senior financial analyst at AFI until September 2000, and James Elliott, the manager of customer financial services at AFI until September 2000, to make false entries in the accounts receivable ledgers and subsidiary ledgers. Beginning in about April 1999, Mr. Grizzle also prepared, at least quarterly, two versions of AFI's trade promotions reserve analysis, one for the company's internal use, which showed an ever-growing trade underaccrual, consisting primarily of items of actual, known expense, and the others to be provided to the auditors, which falsely showed an overaccrued position.

The complaint also alleges that at another of the company's divisions, Timothy B. Andersen, the vice-president of finance and principal financial officer at Aurora's Van de Kamp's division (VDK) until June 2000, carried out Ms. Cummings's and Mr. Chung's instructions to reduce expenses on the books to enable Aurora to hit "must make" numbers on a quarterly or more frequent basis. In almost every instance, in order to hit these earnings targets, Mr. Andersen reduced trade promotion expense and the accompanying trade promotion accrual, even though he knew that the division had already recorded insufficient trade expense and had under-accrued the trade promotion reserve.

According to the SEC complaint, Mr. Andersen allegedly accomplished this by directing VDK's director of budget and planning to reduce the trade promotion accrual. Because the division's computers automatically posted accruals to the reserve account as sales were posted, the automated entries had to be adjusted manually. However, the complaint alleges that Ms. Cummings eventually became concerned that these manual entries would draw audit scrutiny and directed Mr. Andersen to turn off the automated posting system. Thereafter, all accruals were posted by hand at the levels dictated by Ms. Cummings.

The complaint alleges that Ms. Cummings directed VDK's director of budgeting and planning to prepare for the auditors a version of the trade reserve analysis employing incorrect assumptions, which, had they been disclosed, would have immediately revealed the inadequacy of the accruals. Mr. Keith Luechtefeld, the controller at Aurora's VDK division until June 2000, was aware of these deliberate underaccruals, and on at least one occasion, carried out Mr. Andersen's instruction to conceal the underaccruals by shifting $2 million from other liability accounts on VDK's books to the trade promotion reserve. These entries had no purpose other than to make it appear to the auditors that the accrual was adequate, when, in fact, it was not.

Allegedly, throughout 1999, division officers at both AFI and VDK regularly informed Aurora CEO, Mr. Wilson, of the substantial trade accrual deficit, but Mr. Wilson refused to take action to correct the problem and, from time to time, noted his concurrence in actions directed by his subordinates Ms. Cummings and Mr. Chung to conceal the underaccrual. The complaint alleges that Mr. Wilson also made several public statements in 1999 concerning the company's financial condition, which failed to disclose the substantial unrecorded trade marketing expense. By January 2000, Mr. Wilson allegedly actively participated in efforts to conceal the false accounting entries from the auditors and personally directed division employees to lie to the auditors.

Finally, SEC alleges that, as a result, Mr. Wilson, Mr. Chung, Ms. Cummings, Mr.Grizzle, Ms. Fancelli, Mr. Andersen and Mr. Luechtefeld violated, or aided and abetted violations of, Section 10(b) of the Securities Exchange Act of 1934 (Exchange Act), and Rule 10b-5; that all of the individual defendants violated Section 13(b)(5) of the Exchange Act and Rule 13b2-1 in connection with a financial reporting fraud involving Aurora; that Mr. Wilson, Mr. Chung and Ms. Cummings also violated Rule 13b2-2 promulgated under the Exchange Act; that Aurora violated Sections 13(a) and 13(b)(2) of the Exchange Act and Rules 12b-20, 13a-1, and 13a-13; and that Mr. Wilson, Mr. Chung and Ms. Cummings, as control persons of Aurora, are liable for Aurora's violations of Sections 13(a) and 13(b)(2) of the Exchange Act and Rules 12b-20 and 13a-13.

The Commission sought a final judgment (1) permanently enjoining each defendant from future violations of the securities laws; (2) ordering Mr. Wilson, Mr. Chung, Ms. Cummings and Mr. Grizzle to disgorge performance bonuses paid to them on the basis of materially overstated earnings, plus prejudgment interest; (3) imposing civil penalties against each defendant

(except Aurora); and (4) barring Mr. Wilson, Mr. Chung, Ms. Cummings, and Mr. Grizzle from serving as an officer or director of a public company.

The company has consented to a permanent injunction from further violations of the reporting and internal control provisions of the federal securities laws. In addition, Ms. Fancelli consented to a permanent injunction from further violations of the antifraud and reporting and internal control provisions of the federal securities laws that ordered her to pay a civil penalty in the amount of $20,000. Likewise, Mr. Elliott consented to a permanent injunction from further violations of the reporting and internal control provisions of the federal securities laws that ordered him to pay a civil penalty in the amount of $10,000. To date, the remaining litigation is pending in the U. S. District Court for the Southern District of New York.

Critical Path, Inc.

Business Overview

Critical Path, Inc. (Critical Path), founded in 1997, provides Internet messaging and infrastructure products and services. The company provides messaging and collaboration services on an outsource basis, including wireless, secure, and unified messaging to basic E-mail and personal information management, and other identity management solutions that simplify user profile management and strengthen information security. Critical Path's customers include more than 700 enterprises, 190 carriers and service providers, 8 national postal authorities, and 35 government agencies. Its primary sources of revenue include providing a wide range of messaging and directory products and services. As of June 30, 2001, it had 784 employees down from 1,041 year-end 2000. For the year ended December 2000 and 2001, Critical Path had assets totaling $498 million and $200 million, respectively.

Restatement Data

In 1999, Critical Path reported revenue of $16.1 million. For the first quarter of 2000, it reported revenue of $24.6 million. During the next quarter revenue increased to $33.5 million, beating analysts' revenue estimates by about $6 million. The company reported a net loss, excluding special charges, for the second quarter of $20.2 million but again beat consensus earnings per share estimates. Critical Path's chief executive officer (CEO) announced second quarter results on July 19, 2000, and predicted that for the fourth quarter Critical Path would for the first time report a profit excluding special charges. In October 2000, Critical Path's CEO publicly stated that the company was increasing its fourth quarter revenue estimate from $54 million to $56 million and reiterated his earlier prediction that the company would earn its first quarterly profit. On November 2, 2000, Critical Path issued a press release reiterating that guidance.

In an Administrative Order issued in February 2002, the Securities and Exchange Commission (SEC or Commission) found that late in 2000, Critical Path took several actions to boost revenue and reduce costs before the end of December 2000 in order to announce a profit for the fourth quarter as predicted. Specifically, SEC made the following findings. In the final week of December 2000 Critical Path's president and vice president of sales concluded that there was no legitimate means by which Critical Path could achieve its revenue and earnings goals. The president told the

vicepresident to get approximately $4 million in “back-pocket”[103] deals and assured the vice president of sales that Critical Path could use its bad debt reserve to absorb the losses when the purported customers failed to pay.[104]

On January 11, 2001, Critical Path’s president directed Critical Path personnel to backdate to December 2000, a $750,000 sale just made to a company. In addition, Critical Path planned to recognize a $7 million sale to a firm that was formed for this transaction and was owned by a group of shareholders who owned a substantial amount of Critical Path stock. With revenue from these transactions, Critical Path would beat consensus estimates for revenue but not earnings for the quarter. However, Critical Path’s finance officer disclosed the backdating of the $750,000 contract to the new chief financial officer (CFO), who corrected the contract date and did not allow the revenue to be recorded in the fourth quarter.

The complaint alleges that on January 17, 2001, Critical Path’s independent accountants, PricewaterhouseCoopers LLP (PwC), told the new CFO that the company should not record as revenue the $7 million transaction with the reseller because in PwC’s view the reseller and the business objectives of the transactions lacked substance.

After the market closed on January 18, 2001, Critical Path announced unaudited condensed consolidated operating results for the fourth quarter and year 2000, “prepared in accordance with generally accepted accounting principles,” which included $52 million in revenue and a net loss of $11.5 million, excluding special charges. Even though the announced results for the fourth quarter were materially overstated, they were below analysts’ estimates for both revenue and earnings.

On January 31, 2001, Critical Path’s new CFO learned about the misconduct and alerted the company’s board, which held an emergency meeting on February 1, 2001. The board took a number of steps, including forming a special committee to conduct an investigation and placing the company’s president, David A. Thatcher, and vice president of sales, Timothy J. Ganley, on administrative leave.

[103]A back-pocket deal is a fictitious sale that would be recorded as revenue only if it was needed to meet earnings targets.

[104]SEC subsequently charged others who were also involved, including William H. Rinehart, who was charged with misleading the auditors.

On February 2, 2001, before the market opened, Critical Path issued a press release announcing that (1) its board of directors had formed a special committee to conduct an investigation into the company's revenue recognition practices, and (2) it now believed that the results the company announced on January 18, 2001 might have been materially misstated.

On February 15, 2001, the company announced that, based on the preliminary results of the special committee investigation, previously announced revenues for the fourth quarter of 2000 would decrease by $6.5 million to $8 million. Of this amount, Critical Path expected that approximately $4.2 million involved transactions that would not result in revenue and that the remainder might result in revenue that would be recognized during 2001. The company further expected that costs and operating expenses for the fourth quarter of 2000 were going to increase by $1 million to $2 million. In addition, the revisions would cause the company's net loss for the fourth quarter of 2000, excluding special charges, to increase in the range of $19 million to $21.5 million.

On April 5, 2001, Critical Path filed its Form 10-K with SEC for fiscal year 2000. The final revisions were greater than originally estimated (table 11). Revenue for the third quarter of 2000 was restated to $35.3 million (down from $45 million). The net loss was restated to $18.6 million (up from $8.7 million), excluding special charges. Revenue for the fourth quarter was revised to $42.3 million (down from $52.0 million announced on January 18, 2001). The total net loss was revised to $23.3 million, compared with $11.5 million previously announced. Likewise, for the year-end, revenue for 2000 was revised to $135.7 million, down from the previously announced $155 million. Net losses were revised to $78.9 million, compared with $57.2 million as previously announced.

Table 11: Selected Financial Data, 2000-2001

Dollars in millions

Affected financial data	Third quarter fiscal year 2000	Fourth quarter fiscal year 2000	Fiscal year 2001
Revenue, as reported or announced	$45.0	$52.0	$155.0
Revenue, as restated	35.3	42.3	135.7
Net income (loss), as reported or announced	(8.7)	(11.5)	57.2
Net income (loss), as reported or announced	(18.6)	(23.3)	78.9

Note: Critical Path's restatement involved both reported (third quarter) and announced (fourth quarter and fiscal year 2001) results.

Source: SEC filings.

In February 2002, Critical Path announced that it had completed a restructuring plan that led to its return to financial stability, including a $95 million transaction by new financial partners that significantly improved its financial position, bringing in $30 million in gross cash proceeds. In its fourth quarter earnings report on February 5, 2002, the company said it had shown revenue growth for its core Internet communications products for three consecutive quarters, and said it expects to achieve positive earnings before interest before interest, taxes, depreciation, and amortization (excluding special charges) in the fourth quarter of 2002.

Accounting/Audit Firm

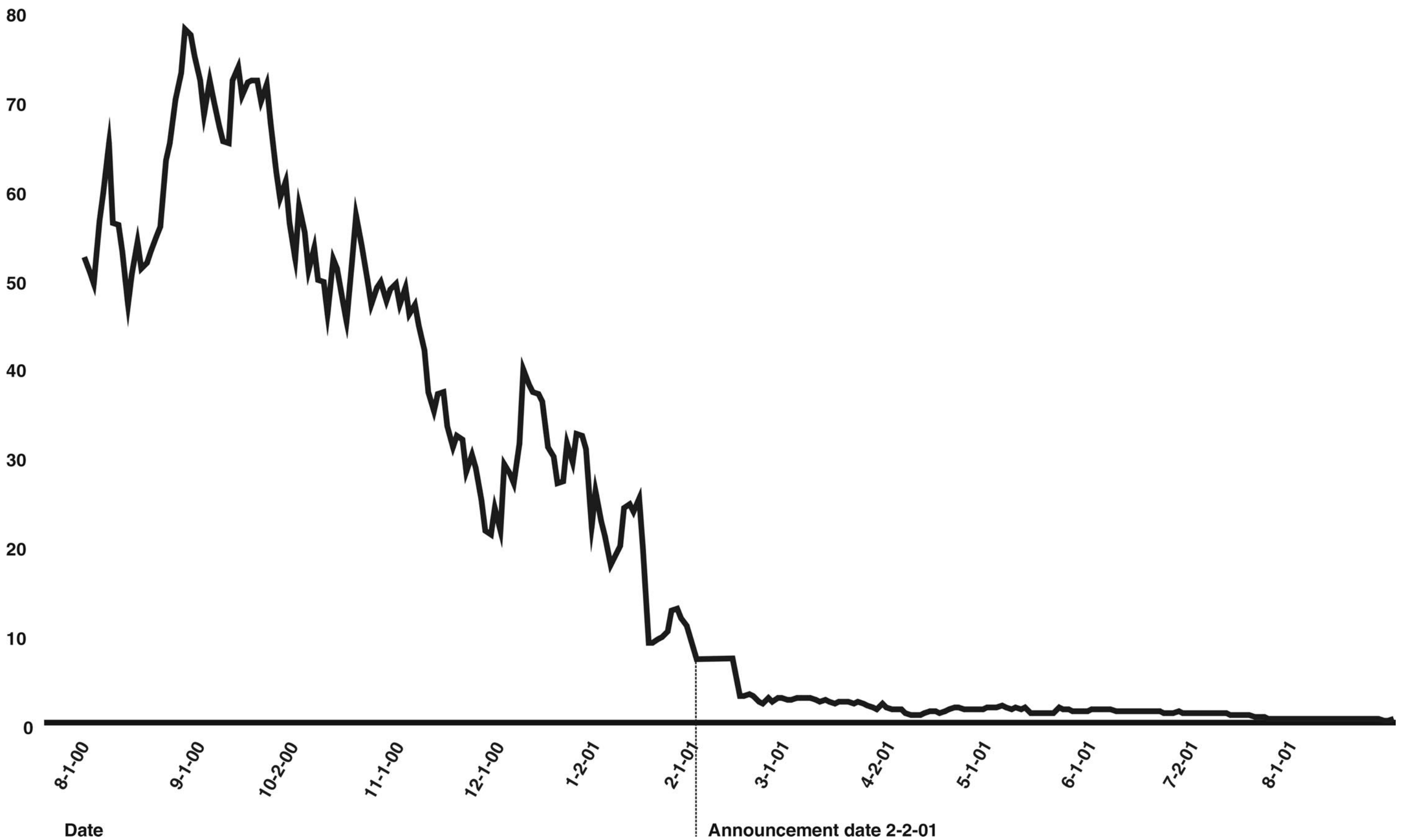
PwC was Critical Path's independent accountant during the restatement period and has been the company's auditor since at least 1999.

Stock Price

Critical Path's common stock trades on the National Association of Securities Dealers Automated Quotation (Nasdaq) under the symbol CPTH. From April 23, 1999, to September 28, 2001, Critical Path's closing stock price ranged from a high of $116.75 to a low of $0.26. On January 19, 2001, the day after Critical Path announced that it would not meet its fourth quarter earnings projection, Critical Path experienced a 55-percent loss in market value. On February 2, 2001, before markets opened, Critical Path announced the pending investigation and trading was suspended pending the release of additional information. Trading resumed on February 15,

2001, when Critical Path announced the preliminary results of its investigation. As figure 14 illustrates, the stock value dropped 70 percent. That is, the stock price closed at $10.06 on February 1, 2001, the day before the announcement of the investigation, and it closed at $3.06 on February 15, 2001, the day it announced the preliminary results. On April 4, 2001, the day before it actually restated its earnings, the stock price closed at $1.53; on the date of the restatement it closed at $1.53; and the day after it closed at $1.06. For this 3-day period the stock dropped 31 percent.

Figure 14: Daily Stock Prices for Critical Path, August 1, 2000-August 31, 2001



Source: GAO's analysis of New York Stock Exchange Trade and Quote data.

Securities Analysts' Recommendations

Based on historical securities analysts recommendations that we were able to identify, we found five analysts that covered Critical Path and all initiated the stock as a buy or accumulate. Three of the five upgraded their ratings later in 1999. In 2000, an additional 14 analysts initiated coverage of Critical Path; all had generally favorable ratings. On November 29, 2000, Critical Path received its first downgrade from a strong buy to a buy. However, on January 19, 2001, the day after Critical Path announced its earnings, which were below estimates, 10 analysts downgraded Critical Path. Several other firms downgraded their initial recommendations on February 2, 2001, the day Critical Path announced that it would have to revise previous revenue and loss estimates for the fourth quarter and year-end 2000 and that it was launching an investigation into accounting irregularities. Two firms downgraded the stock for a second time on February 2, 2001, to market perform. One of the two firms made an additional downgrade on the stock on February 16, 2001.

Credit Rating Agency Actions

Standard and Poor's long-term credit rating for Critical Path's debt indicated that Critical Path's obligations were more vulnerable to nonpayment than higher-rated companies but that it currently had the capacity to meet its financial commitment on the obligation. In addition, such a rating indicated that adverse business, financial, or economic conditions will likely impair Critical Path's capacity or willingness to meet its commitment on the obligation. By May 15, 2001, it had been downgraded and was considered "currently vulnerable" and dependent on favorable business, financial, and economic conditions to meet its commitments. On March 12, 2002, Critical Path was not rated, and according to Standard and Poor's, its future-rating outlook was not meaningful.

Legal and Regulatory Actions Taken

In early 2001, shareholders filed lawsuits against Critical Path to recover damages caused by the defendants' alleged violation of federal securities laws. In November 2001, Critical Path settled class-action lawsuits brought by shareholders against the company and several of its former officers and directors. The settlement provided for $17.5 million in cash and the issuance of warrants to purchase 850,000 shares of Critical Path common stock at an exercise price of $10 per share. The cash settlement amount will be covered by the company's liability insurance. Also in November 2001, Critical Path settled related derivative action. The derivative litigation settlement provides for certain corporate governance changes and the

payment of plaintiffs' attorney fees. In a separate matter, on April 3, 2002, shareholders voluntarily withdrew lawsuits that had been filed in February and March of 2002.

In February 2001, SEC issued a formal order of investigation of Critical Path and certain unidentified individuals associated with Critical Path. The investigation related to accounting matters, financial reports, other public disclosures, and trading activity in its stock. In February 2002, without admitting or denying SEC's findings, Critical Path consented to an administrative order finding that the company violated the periodic reporting, books and records, and internal control provisions of the Securities Exchange Act of 1934 (Exchange Act) and SEC Rule 13a-13.[105] The order directs Critical Path to cease and desist from committing or causing violations of those provisions. SEC did not fine the company.

SEC initiated civil actions against Mr. Thatcher; Mr. Ganley, the vice president of sales for Critical Path; William H. Rinehart, the head of Critical Path's North and Latin American sales forces from November 1998 until February 2001; Jonathan A. Beck, a vice president of sales at Critical Path from November 1998 until February 2001; and Kevin P. Clark, a regional vice president of sales from November 1998 until February 2001. SEC's investigation in this matter is continuing.

Without admitting or denying SEC's allegations, Mr. Thatcher consented to a final judgment permanently enjoining him from violating antifraud, reporting, books and records, and internal control provisions of the Exchange Act and SEC rules and from aiding and abetting such violations. The court also barred him for 5 years from serving as an officer or director of any public company and ordered him to pay a civil penalty in the amount of $110,000.

Mr. Ganley was charged with participating in one of the eight back-pocket transactions, and it was alleged that he then illegally sold 1,300 shares of Critical Path stock in January 2001 based on information he possessed about the fraud and the company's true financial condition. Without admitting or denying SEC's allegations, Mr. Ganley consented to the entry of final judgment permanently enjoining him from violating antifraud and books and record provisions of the Exchange Act and related SEC rules

[105]See 15 U.S.C. § 78m (2000); respectively, and SEC Regulation 13A, 17 C.F.R. § § 240.13a-13, et seq. (2002).

and from aiding and abetting violations of books and records and internal control requirements of the Exchange Act. He was also ordered to pay over $105,900 in penalties and disgorgement. Specifically, he had to disgorge a $27,950 loss he avoided by engaging in insider trading, plus prejudgment interest. Mr. Ganley also had to pay a $27,950 civil penalty for insider trading and a $50,000 civil penalty for his participation in the fictitious transaction that was part of the financial fraud.

Mr. Rinehart was charged with directing his sales force to arrange—and in each instance personally participated in—certain transactions for which Critical Path improperly recorded revenue of approximately $6.3 million for the fourth quarter of fiscal 2000. He then falsely stated in a letter to Critical Path's auditors that all of the company's sales were bonafide. Without admitting or denying the Commission's allegations, Mr. Rinehart consented to the entry of final judgments permanently enjoining him from violating Sections 10(b) and 13(b)(5) of the Exchange Act and Exchange Act Rules 10b-5, 13b2-1 and 13b2-2, and from aiding and abetting violations of Sections 13(b)(2)(A) and 13(b)(2)(B) of the Exchange Act. He was also ordered to pay a $110,000 civil penalty for his participation in the financial fraud and barred from acting as an officer or director of a public company for 5 years.

Mr. Clark was also charged with participating in one of these fraudulent transactions, for which Critical Path improperly recorded revenue totaling approximately $2.125 million. Mr. Clark, without admitting or denying the Commission's allegations, consented to the entry of final judgments permanently enjoining him from violating Sections 10(b) and 13(b)(5) of the Exchange Act and Exchange Act Rules 10b-5, 13b2-1 and 13b2-2, and from aiding and abetting violations of Sections 13(b)(2)(A) and 13(b)(2)(B) of the Exchange Act. He was also ordered to disgorge $343,140 plus $35,772 prejudgment interest.

The complaint alleges that Mr. Beck participated on one of the fraudulent transactions, for which Critical Path improperly recorded revenue totaling about $2.125 million. SEC alleges that Mr. Beck violated, or aided and abetted violations of the antifraud, books and records, internal accounting controls, and reporting provisions of the federal securities laws. The Commission's complaint further alleges that Mr. Beck illegally sold 27,348 shares of Critical Path stock based on nonpublic information he possessed about the fraud and the company's true financial condition. By selling shares while the fraud was under way, Mr. Beck avoided losses of $586,368. SEC asked the court to permanently restrain and enjoin Mr. Beck from

violating Sections 10(b) and 13(b)(5) of the Exchange Act and Exchange Act Rules 10b-5 and 13b2-1, and from aiding and abetting violations of Sections 13(b)(2)(A) and 13(b)(2)(B) of the Exchange Act. SEC also seeks a civil monetary penalty and disgorgement of ill-gotten gains.

SEC also entered an administrative order against David A. Thatcher, the president of Critical Path from January 2000 to February 2001 and acting CFO from December 6, 2000, to January 3, 2001. Prior to becoming president of Critical Path in January 2000, he served as CFO from December 1998 to January 2000. In addition, he intermittently served on the board of directors since 1997. He was a licensed certified public accountant and signed off on Critical Path's Form 10-Q filed with SEC for the first 3 quarters of 1999.

On February 5, 2002, the U.S. Attorney's Office announced that it had filed securities fraud charges against Mr. Thatcher, the former president, and the unsealing of insider trading charges against Mr. Ganley, the former sales vice president. Mr. Thatcher was charged with conspiracy to commit securities fraud in violation of 18 U.S.C. § 371. According to the announcement, he and others conspired to improperly record and accelerate revenues during the third and fourth quarters of 2000. On January 12, 2002, Mr. Thatcher pled guilty to the securities fraud charges. Specifically, he admitted participation in six transactions for which Critical Path improperly recognized revenue during the third and fourth quarters of 2000. He faces a maximum statutory penalty of 5 years imprisonment, a $250,000 fine, and 3 years supervised release. As of September 19, 2002, Mr. Thatcher had not been sentenced.

Mr. Ganley, the former sales vice president, was charged with insider trading in violation of 15 U.S.C. § 78j(b), 15 U.S.C. § 78ff(a) and 17 CFR 240.10b-5. According to the January 9, 2002 grand jury indictment, he sold Critical Path stock on January 11, 2001, while aware that the company was recording false revenues and fraudulently under-recording expenses in an ultimately unsuccessful attempt to meet its publicly stated goal of profitability during the fourth quarter of 2000. On April 10, 2002, he pled guilty to insider-trading charges. He admitted that on January 11, 2001, he sold Critical Path stock on the basis of material inside information in violations of securities laws. He faced a maximum statutory penalty of 10 years imprisonment, a $1 million fine, and 3 years supervised release. On September 10, 2002, Mr. Ganley was sentenced to 6 months imprisonment, 2 years supervised release with a condition of 6 months home detention, and a $100 special assessment.

On August 27, 2002, the U.S. Attorney's Office for the Northern District of California announced criminal charges against Messrs. Beck and Clark for insider trading. Both are expected to appear in court later in the year.

Enron Corporation

Business Overview

Enron Corporation (Enron) provides products and services related to natural gas, electricity, and communications to wholesale and retail customers through subsidiaries and affiliates. Enron's activities are divided into five segments: transportation and distribution, wholesale services, retail energy services, broadband services, and other. Enron operates in the United States, Canada, Europe, Japan, Australia, South America, and India. Wholesale services accounted for 93 percent of 2000 revenues; retail energy services, 4 percent; transportation and distribution, 3 percent; and broadband services and other services, less than 1 percent. On December 2, 2001, Enron and 13 of its subsidiaries filed for Chapter 11 bankruptcy protection under the federal bankruptcy code.

Restatement Data

On October 16, 2001, Enron announced its third quarter 2001 numbers, a net loss of $618 million, which included a $544 million charge characterized as a nonrecurring item related to the termination of "certain structured finance arrangements" (table 12).[106] On October 26, 2001, a special committee of Enron's board of directors began a review of transactions between Enron and certain related parties. The board hired Wilmer, Cutler & Pickering as its counsel, which hired Deloitte & Touche LLP to provide accounting advice.

On November 8, 2001, Enron announced that it would restate earnings for the period 1997 through 2001 to reflect (1) recording the previously announced $1.2 billion reduction to shareholders' equity reported by Enron in the third quarter of 2001 and (2) various income statement and balance sheet adjustments required as the result of a determination by Enron and its auditors (which resulted from information made available from further review of certain related-party transactions) that three unconsolidated entities should have been consolidated in the financial statements pursuant to generally accepted accounting principles (GAAP).

[106] Structured finance arrangements are a technique whereby certain assets with more or less predictable cash flows can be isolated from the originator and used to mitigate risks (e.g., transfer of foreign exchange, contract performance, and sovereign risk), and thus secure a credit.

Enron, like many other companies, utilized a variety of structured financings in the ordinary course of its business to access capital or hedge risk.[107] Many of these transactions involved special purpose entities (SPE).[108] Accounting guidelines allowed for SPEs to report separately from the sponsoring company's financial statements in certain circumstances, and in other cases the SPEs' financial results should be recorded with the sponsoring company's results.[109] Accordingly, certain transactions between the sponsoring company and the SPE may result in gains or losses or cash flow being recognized by the sponsor, commonly referred to by financial institutions as "monetizations." Enron established several SPEs; most notable were Joint Energy Development Investments, L. P. (JEDI); Chewco Investments, L.P. (Chewco); LJM Cayman, L.P. (LJM1); and LJM2 Co-Investment, L.P. (LJM2) referred to collectively as the LJMs.

JEDI was established in 1993 as a partnership between Enron and California Public Employees' Retirement System (Calpers) to invest in natural gas projects. In 1997, Enron wanted to expand JEDI, but Calpers was reluctant. Andrew Fastow, then chief financial officer (CFO), created Chewco, which was setup in 1997 to buy out the interest of Calpers investment in JEDI, which was valued at $383 million. The LJMs were private investment limited partnerships that were formed in 1999. Mr. Fastow was (from inception through July 2001) the managing member of the general partners of the LJMs.

Enron restated its financial statements from 1997 through 2000 and the first and second quarters of 2001 to (1) reflect the conclusion that three entities mentioned above did not meet certain accounting requirements and should have been consolidated, (2) reflect the adjustment to shareholders' equity, and (3) include prior-year proposed audit adjustments and reclassifications

[107]A hedge is an investment made in order to reduce the risk of adverse price movements in a security by taking an offsetting position in a related security, such as an option or a short sale.

[108]An SPE is a business interest formed solely in order to accomplish some specific task or tasks. A business may utilize an SPE for accounting purposes, but these transactions must still adhere to certain regulations.

[109]For SPE partnerships, consolidation was not required if, among other things, an independent third party invested at least 3 percent of the capital. The Financial Accounting Standards Board is proposing to raise this threshold and change other conditions for avoiding consolidation on the sponsor's balance sheet.

(that were previously determined to be immaterial in the year originally proposed).

Specifically, Enron concluded that based on current information the financial activities of Chewco, a related party that was an investor in JEDI, should have been consolidated beginning in November 1997. The financial activities of JEDI, in which Enron was an investor and which were consolidated into Enron's financial statements during the first quarter of 2001, should have been consolidated beginning in November 1997; and the financial activities of a wholly owned subsidiary of LJM1, which engaged in transactions with Enron to permit Enron to hedge market risks of an equity investment in Rhythms NetConnections, Inc., should have been consolidated into Enron's financial statements beginning in 1999.

Enron indicated that the restatement would include a reduction to reported net income of approximately $96 million in 1997, $113 million in 1998, $250 million in 1999, and $132 million in 2000, and would also include increases of $17 million for the first quarter of 2001 and $5 million for the second quarter, and a reduction of $17 million for the third quarter of 2001 (table 12). These changes to net income were the result of the retroactive consolidation of JEDI and Chewco (November 1997), the consolidation of the LJM1 subsidiary for 1999 and 2000 and prior year proposed audit adjustments. The consolidation of JEDI and Chewco also increased Enron's debt by approximately $711 million in 1997, $561 million in 1998, $685 million in 1999, and $628 million in 2000 (table 12). Enron expected the restatement would have no negative impact on its reported earnings for the 9-month period ending September 2001.

Table 12: Selected Financial Data 1997-2001

Dollars in millions

Affected financial data	Fiscal year 1997	Fiscal year 1998	Fiscal year 1999	Fiscal year 2000	First quarter 2001	Second quarter 2001	Third quarter 2001
Net income (loss), as reported	$105	$703	$893	$979	$425	$404	$(618)
Net income (loss), anticipated restatement	9	590	643	847	442	409	(635)
Debt, as reported	6,254	7,357	8,152	10,229	11,922	12,812	N/A
Debt, anticipated restatement	6,965	7,918	8,837	10,857	11,922	12,812	12,978

Note 1: As of September 14, 2002, Enron had not filed its 2001 Form 10-K or amendments to its 1997 through 2000 financial reports to reflect the impacts of the anticipated restatements.

Note 2: N/A means not applicable.

Source: SEC filing.

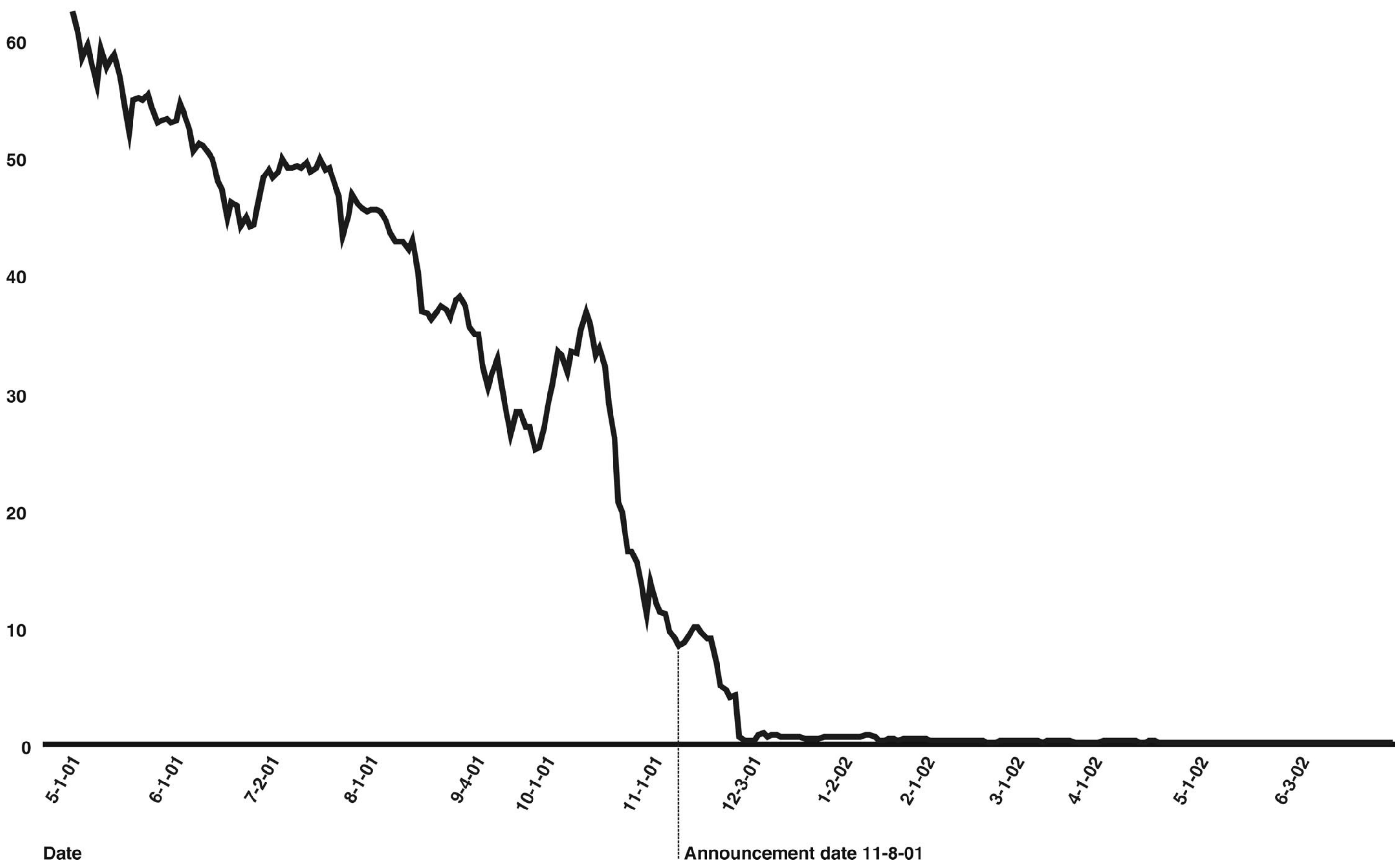
Accounting/Audit Firm

Arthur Andersen LLP (Arthur Andersen) was Enron's independent auditor from 1985 to 2001. On January 17, 2002, Arthur Andersen was discharged by Enron's board of directors. As of August 2002, the company did not have an independent auditor, and based on discussions with independent auditing firms, Enron management believed that the retention of an auditor is not feasible. Enron's October 16, 2001, press release characterized numerous charges against income for the third quarter as nonrecurring, even though Arthur Andersen believed the company did not have a basis for concluding that the charges would in fact be nonrecurring. According to the U.S. Department of Justice indictment against Arthur Andersen, Arthur Andersen allegedly advised Enron against using the term "nonrecurring" and documented its objections internally in the event of litigation but did not report its objections or otherwise take steps to cure Enron's public statement. The Department of Justice alleged that Arthur Andersen was put on direct notice of the allegations of Sherron Watkins, an Enron employee and former Arthur Andersen employee, regarding possible fraud and other improprieties at Enron. In particular, she noted the possibility of fraud in Enron's use of off-balance-sheet SPEs that enabled the company to camouflage the true financial condition of the company. Ms. Watkins had reported her concerns to a partner at Arthur Andersen, who thereafter allegedly disseminated them within Arthur Andersen, including to the team working on the Enron audit.

Stock Price

Enron's stock traded on the New York Stock Exchange (NYSE) under the ticker symbol ENE. After being delisted from NYSE, Enron trades on the over the counter under the ticker symbol ENRNQ. Enron's stock experienced a marked decline from May 2001 to October 2001, falling from over $60 per share to under $30 per share. Following the October 16, 2001, announcement of its third quarter net loss, which included a $544 million loss on a structured finance arrangement, Enron's stock price fell almost 75 percent from $33.84 to $9.05 by November 7, 2001, the day before it announced that it would restate earnings for 1997 through 2001 (fig.15). In the days surrounding the restatement announcement, its stock price fell from $9.05 to $8.63, a drop of less than 5 percent. Shortly thereafter, following a precipitous decline from over $9 to just over $4 in the weeks following the restatement announcement, the stock lost 85 percent of its remaining value on November 28, 2001, dropping from $4.14 to $0.61, after a buyout by Dynegy Inc., fell through and bankruptcy appeared inevitable. As of September 13, 2002, the stock price closed at $0.16.

Figure 15: Daily Stock Prices for Enron, May 1, 2001–June 28, 2002



Source: GAO's analysis of NYSE Trade and Quote and Nasdaq data.

Securities Analysts' Recommendations

Based on available historical securities analyst information we were able to identify, as of October 18, 2001, 15 firms rated Enron a buy—12 of the 15 considered the stock a strong buy. Even as late as November 8, 2001, the date of Enron's disclosure that nearly 5 years of earnings would have to be recalculated, although most firms downgraded their ratings, 11 of 15 continued to recommend buying the stock, 3 recommended holding, and

only 1 recommended selling. In November 2001, one firm upgraded its recommendation from sell to hold.

Credit Rating Agency Actions

Moody's Investors Service, Inc. (Moody's), and Standard and Poor's rated Enron. Each reacted differently to Enron's October 16, 2001, announcement of third-quarter losses. Standard and Poor's affirmed Enron's medium grade rating, which indicated that Enron had adequate capacity to meet its financial commitments. However, its rating also indicated that adverse economic conditions or changing circumstances were more likely to lead to a weakened capacity to meet financial commitments. Moody's placed all of Enron's long-term debt on review for possible downgrade. Both firms continued to downgrade Enron's debt and commercial paper throughout October and November 2001. On December 3, 2001, the day after Enron filed for bankruptcy protection under Chapter 11, Standard and Poor's lowered Enron's rating to reflect its view that a default was likely and that Enron would fail to pay all or substantially all of its obligations when they came due. Moody's downgraded Enron's long-term debt ratings and senior unsecured debt to a low grade indicating that a partial recovery was possible.

Legal and Regulatory Actions Taken

Enron is a defendant in several civil lawsuits. Early in 2002, a class-action lawsuit was filed against Enron in the U.S. District Court for the Southern District of Texas. Among other things, the complaint alleges that certain Enron executives and directors, its accountants, law firms, and banks violated securities laws and conducted massive insider trading while making false and misleading statements. The trial is scheduled to begin on December 1, 2003. On December 2, 2001, Enron and 1,500 of its subsidiaries filed for Chapter 11 bankruptcy protection under the federal bankruptcy code.[110]

On October 17, 2001, the day after Enron initially announced a large loss, the Securities and Exchange Commission (SEC or Commission) began an investigation by requesting in writing information from Enron. By October 19, 2001, Enron had notified Arthur Andersen that SEC had begun an

[110]Pursuant to the automatic stay provisions of Section 362 of the Federal Bankruptcy Code, 11 U.S.C. § 362, actions to collect pre-petition indebtedness and virtually all litigation against the debtor that was or could have been brought prior to commencement of a Chapter 11 bankruptcy proceeding are stayed unless the stay is lifted by the court.

inquiry regarding Enron's SPEs and the involvement of Enron's CFO. According to the Department of Justice action, on October 23, 2001, Arthur Andersen's Enron engagement team allegedly began the wholesale destruction of documents at Arthur Andersen's offices in Houston, Texas, under orders from Arthur Andersen partners. On or about November 8, 2001, SEC served Arthur Andersen with a subpoena relating to its work for Enron. It was at that point that Arthur Andersen's Enron team was instructed to halt destroying documents because the firm had been officially served a subpoena. Arthur Andersen's lead Enron auditor, David B. Duncan, pled guilty to obstruction of justice charges on April 9, 2002, and cooperated with authorities. On June 15, 2002, Arthur Andersen was found guilty of obstruction of justice. Arthur Andersen is appealing the decision. Also, on June 15, 2002, Arthur Andersen notified SEC that as of August 31, 2002, it would cease to practice before SEC. On September 2, 2002, Arthur Andersen announced that it had surrendered to state regulators all licenses "to practice public accountancy."

SEC filed a subpoena enforcement action against Mr. Fastow, former CFO, for failing to appear for testimony before SEC staff on December 12, 2001. On August 20, 2002, the Department of Justice filed suit against Michael J. Kopper, charging him with money-laundering conspiracy and conspiracy to commit wire fraud. The following day, August 21, 2002, SEC charged former senior Enron official Michael J. Kopper with violating the antifraud provisions of the federal securities laws. As of August 2002, no other legal action has been taken against Enron or its current or former employees by government agencies; however, investigations continue.

Hayes Lemmerz International, Inc.

Business Overview

Hayes Lemmerz International, Inc. (Hayes) is a supplier of automotive and commercial highway wheels, brakes, power train, suspension, structural and other lightweight components. The company's principal customers for wheel and brake products consist of every major original equipment manufacturer in North America, Europe, and Japan. The company has 46 plants, 6 joint venture facilities, and over 14,000 employees worldwide. For the fiscal year ended January 31, 2001, Hayes had net sales of $2 billion. On December 5, 2001, the company and certain of its subsidiaries filed for Chapter 11 bankruptcy protection under the federal bankruptcy code.

Restatement Data

On September 5, 2001, the company announced that it would restate financial results for fiscal 2000 and the first quarter of fiscal 2001. According to its press release, these restatements would correct errors that the company and its auditors, KPMG LLP, identified in the accounting for certain items and write down the value of certain impaired assets at one of its manufacturing plants. In addition, Hayes announced that its audit committee of the board of directors was given the responsibility to investigate these accounting errors. The audit committee engaged Skadden, Arps, Slate, Meagher & Flom LLP and Ernst & Young LLP to advise it during this review. Subsequently, Hayes formally notified the Securities and Exchange Commission (SEC or Commission) that its Form 10-Q for the fiscal quarter ended July 31, 2001, would be delayed.

On December 13, 2001, Hayes announced that it had substantially completed its accounting investigation and restatement for fiscal 2000 and the first quarter of 2001. In addition, Hayes announced that it was also restating its financial results for the fiscal year 1999 and related quarters. On February 19, 2002, Hayes filed its amended Form 10-K with SEC, which restated its financial statements and cumulatively reduced previously reported net income for fiscal years 1999 and 2000 and the first quarter of fiscal 2001 by $218 million in total (table 13). The company also reported that earnings before interest, taxes, depreciation, and amortization (EBITDA), a measure of operating performance, would be reduced by $96.4 million. In addition, Hayes reported that non-EBITDA adjustments related primarily to asset impairment losses, increases in deferred income tax valuation allowances, and restructuring charges.

Table 13: Selected Financial Data, 1999-2001

Dollars in millions

Affected financial data	Fiscal year 1999	Fiscal year 2000	First quarter 2001
Net income (loss), as reported	$65.1	$(41.8)	$(7.6)
Net income (loss), as restated	47.6	(186.2)	(63.7)

Source: SEC filings.

Accounting/Audit Firm

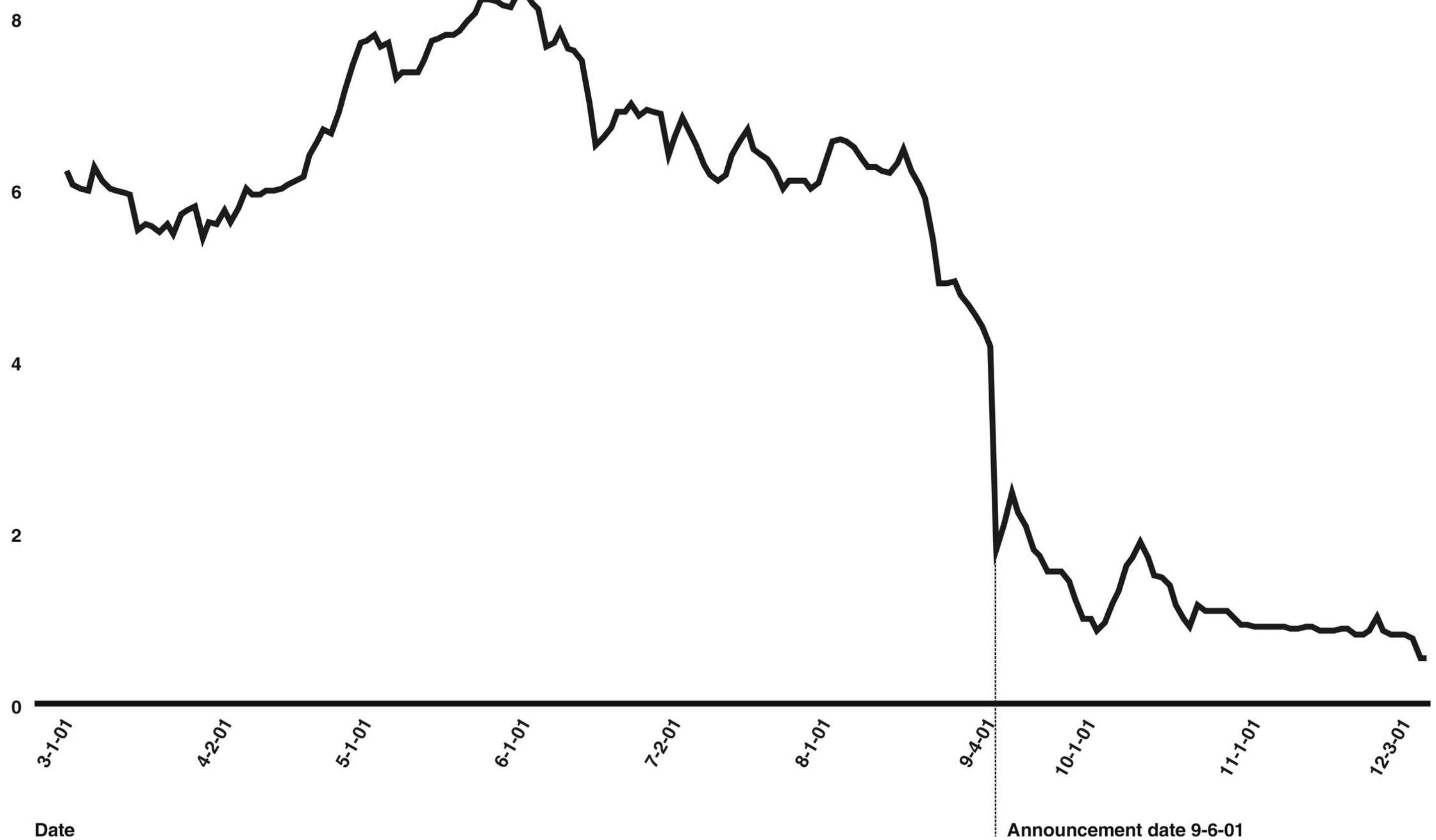
KPMG LLP was the company's independent auditor. As of June 2002, KPMG LLP continued in that capacity.

Stock Price

The company's common stock was traded on the New York Stock Exchange (NYSE) under the ticker symbol HAZ. However, trading was suspended on December 6, 2001, after it filed for bankruptcy. Its stock was delisted on February 8, 2002. The company now trades over the counter under the ticker symbol HLMMQ.

In March 2001, Hayes traded at over $6 per share and trended upward to over $8 a share in June 2001. It remained volatile throughout August 2001. On September 4, 2001, the day before it announced its financial restatement and the initiation of an internal investigation into its accounting practices, Hayes's shares closed at $4.15. On September 6, 2001, the day after the announcement, it closed at $1.80 per share (see fig. 16), a decline of more than 50 percent. When the company filed for bankruptcy on December 5, 2001, its stock price had fallen to $0.50 per share.

Figure 16: Daily Stock Prices for Hayes, March 1, 2001-December 6, 2001



Note: NYSE suspended trading of Hayes's stock on December 6, 2001.

Source: GAO's analysis of NYSE Trade and Quote data.

Securities Analysts' Recommendations

Based on available historical securities analyst information we were able to identify, on November 21, 2000, almost a year before the restatement announcement, one analyst downgraded Hayes's rating from a buy to neutral. In the week before the financial restatement, another analyst downgraded his recommendation on Hayes from buy to hold. On

December 6, 2001, the same firm stopped its coverage of Hayes after the bankruptcy filing.

Credit Rating Agency Actions

Both Moody's Investors Service, Inc. (Moody's) and Standard and Poor's rated the company's debt before and during the restatement period. In October 2000, Moody's rated Hayes's debt as poor, generally lacking characteristics of a desirable investment. In April 2001, Standard and Poor's gave Hayes debt a generally comparable weak rating, which indicated that Hayes had the capacity to meet its financial obligations but was vulnerable to adverse business, financial, or economic conditions. In June 2001, Moody's downgraded Hayes's subordinated debt to very poor but considered its outlook stable. On September 6, 2001, the day after the restatement announcement and internal investigation, Standard and Poor's maintained Hayes's debt rating but assigned its outlook as negative. On the following day, September 7, 2001, Moody's downgraded Hayes's debt further and placed the company on review for a further downgrade. In October, Moody's and Standard and Poor's downgraded Hayes's credit rating once again. On December 6, 2001, the day after Hayes filed for Chapter 11 bankruptcy protection, Standard and Poor's downgraded its rating indicating that it had filed for bankruptcy protection. In January 2002, Standard and Poor's placed Hayes on its nonrated list.

Legal and Regulatory Actions Taken

On December 5, 2001, the company, its domestic subsidiaries, and one subsidiary in Mexico filed voluntary petitions under Chapter 11 of the U.S. Bankruptcy Code.[111]

In May 2002, a group of Hayes bondholders brought a class-action lawsuit against 13 present and former directors and officers of Hayes (but not the company) and KPMG LLP in the U.S. District Court for the Eastern District of Michigan. The complaint seeks damages for a class of persons who purchased Hayes bonds between June 3, 1999, and September 5, 2001, and claim to have been injured because they relied on the allegedly false and misleading financial statements. The complaint was subsequently amended to add CIBC World Markets Corp. and Credit Suisse First Boston

[111]Pursuant to the automatic stay provisions of Section 362 of the Federal Bankruptcy Code, 11 U.S.C. § 362, actions to collect pre-petition indebtedness and virtually all litigation against the debtor that was or could have been brought prior to commencement of a Chapter 11 bankruptcy proceeding are stayed unless the stay is lifted by the court.

Corporation, underwriters for certain bonds issued by Hayes, as defendants.

Before the date Hayes commenced Chapter 11 bankruptcy, four class actions were filed in the U.S. District Court for the Eastern District of Michigan against Hayes and certain of its directors and officers, on behalf of purchasers of Hayes's common stock from June 3, 1999, to December 13, 2001, based on similar allegations of securities fraud. On May 10, 2002, the plaintiffs filed a consolidated and amended class-action complaint seeking damages against present and former Hayes officers and directors (but not the company).

According to the Hayes September 16, 2002, Form 10-Q filed with SEC, Hayes was under investigation by SEC for accounting errors found in its fiscal 1999, 2000, and the first quarter of fiscal 2001 statements.

JDS Uniphase Corporation

Business Overview

JDS Uniphase Corporation (JDS Uniphase) is a technology company that designs, develops, manufactures, and distributes fiber-optic components, modules and subsystems for the fiber-optic communications industry. These products are deployed in optical communications networks for the data communications, telecommunications, and cable television industries and include source and pump lasers and modulators to send signals across fiber-optic networks, as well as passive components that amplify and guide optical signals on their way. JDS Uniphase and its subsidiaries also use optics technology to offer products and solutions in other markets, including optical coatings, biomedical instruments, semiconductors and graphic arts. Nortel Networks, Alcatel, and Lucent account for a combined 36 percent of sales; other customers include CIENA, Tyco, Cisco, Compaq and Motorola.

According to company documentation, JDS Uniphase is the product of a number of substantial mergers and acquisitions, including the combination of Uniphase Corporation and JDS Fitel Inc., to form JDS Uniphase Corporation on June 30, 1999, and the subsequent acquisitions of Optical Coating Laboratory, Inc., (OCLI) on February 4, 2000; E-Tek Dynamics, Inc., (E-Tek) on June 30, 2000; and SDL, Inc., (SDL) on February 13, 2001. In 2001, JDS Uniphase sold a Zurich based pump laser manufacturing plant to Nortel to gain regulatory approval for the SDL acquisition. JDS Uniphase has planned additional facility closures and has laid off more than 50 percent of its staff in response to lagging sales and massive losses incurred from write-downs of its acquisitions.

Restatement Data

On April 24, 2001, JDS Uniphase announced that it was evaluating the value of certain “long-lived” assets related to recent acquisitions and that the evaluation might result in an approximately $40 billion reduction in goodwill[112] for the quarter ended March 31, 2001. On May 11, 2001, JDS Uniphase filed its financial statements for the quarter ended March 31, 2001, with the Securities and Exchange Commission (SEC or Commission), reporting a net loss of $1.29 billion, which did not include charges related to goodwill impairment. On July 26, 2001, JDS Uniphase announced it was recording reductions of $38.7 billion and $6.1 billion in goodwill and other intangible assets for the quarters ended March 31, 2001, and June 30, 2001,

[112]In an acquisition, goodwill is the excess of purchase price over the fair market value of the net assets of the acquired company.

respectively. The company also announced that it was conducting a further assessment of its long-lived assets and that additional adjustments to fiscal 2001 results might be necessary. This review resulted in JDS Uniphase recording additional charges to reduce goodwill and other long-lived assets of $1.1 billion and $4.2 billion during the quarters ended March 31, 2001, and June 30, 2001, respectively. The financial statements reflecting these charges, including the restated figures for the quarter ended March 31, 2001, were filed with SEC on September 19, 2001. The restatement increased the company's net loss from the originally reported amount of $1.3 billion to a restated loss of $41.9 billion (table 14).

Table 14: Selected Financial Data, March 2001

Dollars in billions

Affected financial data	Third quarter fiscal year 2001
Net loss, as reported	$1.3
Net loss, as restated	41.9

Source: SEC filing.

In addition to the $39.8 billion reduction in the carrying value of goodwill, the financial statements for the quarter ended March 31, 2001, were restated to (1) reclassify $300.9 million in amounts paid to certain SDL executives in connection with the acquisition as compensation expense for the period, rather than acquisition costs as previously reported; (2) adjust for other acquisition costs related to the acquisitions of SDL and E-TEK for $16.8 million; and (3) record a charge of $714.5 million to write down the value of the company's investment in ADVA, a publicly traded German company, due to an other than temporary decline in its fair value.

According to its SEC filing, JDS Uniphase sought guidance from SEC on valuing goodwill, ultimately deciding to take charges to reduce the carrying value of goodwill. The goodwill assessment carried out by JDS Uniphase was due to a significant sustained decline in industry market conditions, which resulted in the value of the company's net assets exceeding the company's market capitalization by approximately $39.8 billion on March 31, 2001. The impairment charges for goodwill and other assets in the restated financials were based on the amount by which the book value of these assets exceeded their fair market value. Fair value was determined based on discounted future cash flows for the operating entities that had

separately identifiable cash flows. Of the total write down, $46.6 billion was related to the goodwill primarily associated with the acquisitions of E-TEK, SDL, and OCLI.

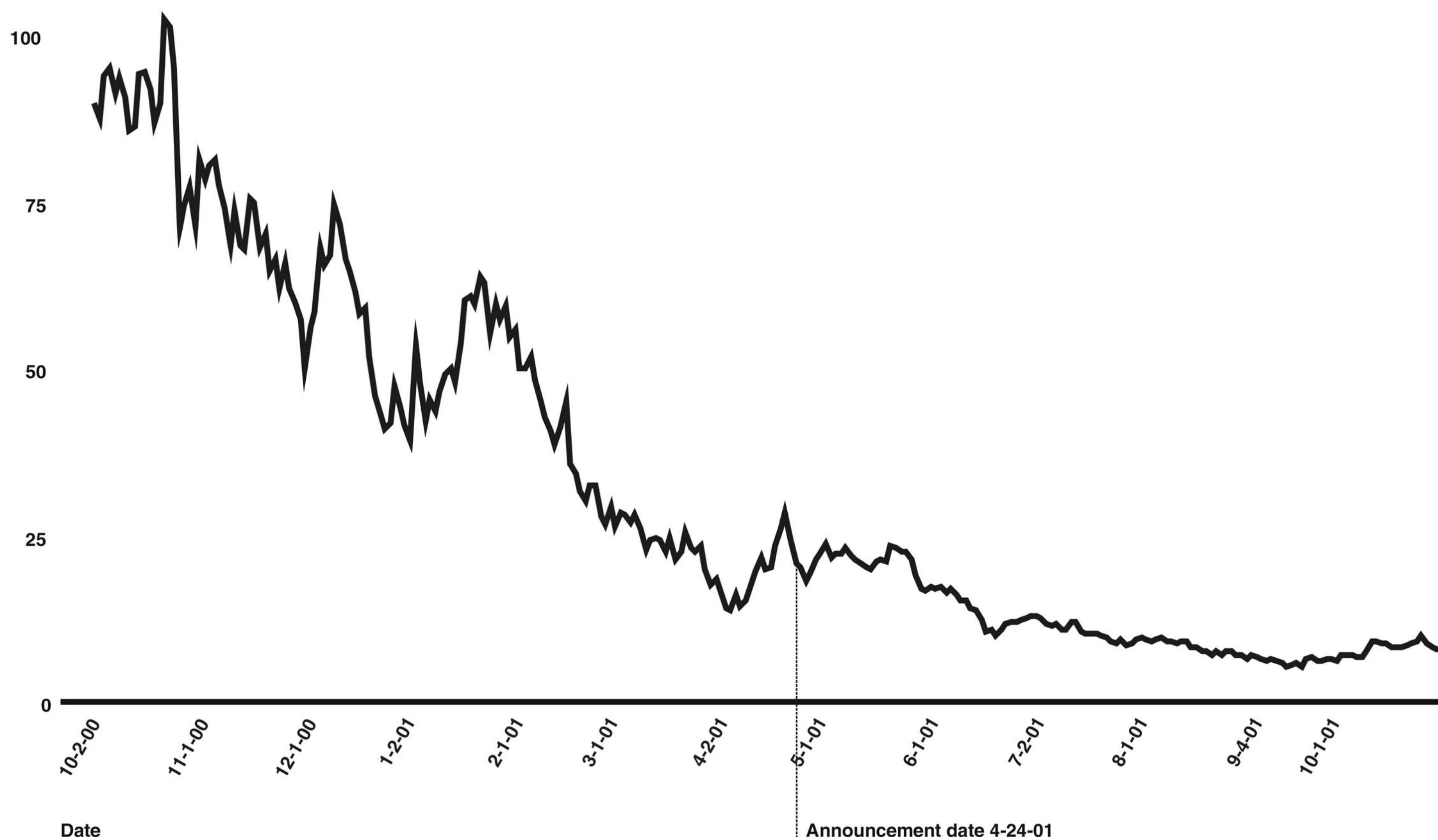
Accounting/Audit Firm

Ernst & Young, LLP (Ernst & Young) was the independent auditor for JDS Uniphase during the relevant period. It has been named in at least one class-action lawsuit filed April 23, 2002.

Stock Price

JDS Uniphase Corporation is traded on the National Association Securities Dealers Automated Quotation (Nasdaq) under the symbol JDSU. On February 4, 2000, when JDS Uniphase initiated a substantial number of acquisitions with the purchase of OCLI, the company's stock price was $105.59 per share. About 1 year later its stock price closed at less than half that price. From February 2001 to April 2001, its stock price continued to fall. On April 24, 2001, when JDS Uniphase announced that its review of the carrying amount of goodwill might result in a significant write-down, the stock price closed at $20.84, down $3.34 or almost 14 percent from the prior day's close (fig. 17). On July 26, 2001, when the company announced the charges for the quarters ended March 31, 2001, and June 30, 2001, the stock price closed at $9.47. Once JDS Uniphase filed its restated financials on September 19, 2001, the stock price further declined to $5.70. This represented a decline of over 70 percent from the initial announcement of the goodwill review on April 24, 2001. Over the same period, the Nasdaq Composite Index lost about 25 percent.

Figure 17: Daily Stock Prices for JDS Uniphase, October 2, 2000–October 31, 2001



Source: GAO's analysis of NYSE and Quote data.

Securities Analysts' Recommendations

Based on historical analyst research information we identified, many firms covered JDS Uniphase in 2001. In the months before the restatement announcement, most firms had begun to downgrade the company's stock to buy, neutral, or add. In April 2001, just days before the restatement announcement, several firms upgraded their recommendations. On the day of the announcement, one firm reiterated its strong buy and another

downgraded its recommendation on JDS Uniphase stock to market perform.

In the period following the restatement announcement, most firms downgraded or reiterated their ratings, which included hold, neutral, buy and market perform. Several of the analysts upgraded the stock in September and October 2001 (the month of and the month following the restatement). Three others downgraded their ratings and one firm made no change. From February 2001 through October 2001, the time period surrounding the events of the restatement and goodwill reduction analyst recommendations included primarily buy and hold or neutral ratings. For example, after the company filed its restated financial statements on September 19, 2001, a number of firms upgraded their recommendations to buy ratings. Throughout 2001, the distribution of buy and hold ratings remained mixed.

Credit Rating Agency Actions

No information was found.

Legal and Regulatory Actions Taken

Several civil lawsuits, including a consolidated class-action suit, have been filed against JDS Uniphase since March 27, 2002. The lawsuits charge JDS Uniphase and certain of its officers and directors with violations of the Securities Exchange Act of 1934. The class-action complaint alleges, among other things, that JDS Uniphase and the other defendants were motivated to inflate the value of JDS Uniphase's stock to finance its acquisitions and to enable top officers and directors of JDS Uniphase to sell their shares. Furthermore, the complaint alleges that JDS Uniphase violated federal securities law by failing to disclose that its earnings were artificially inflated due to the company's failure to record write-downs of goodwill and other intangible assets associated with the mergers between Uniphase Corp., OCLI, E-Tek, and SDL and JDS Uniphase after it had become apparent that such assets were being carried at unrealistically and misleadingly high values. In at least one of the lawsuits, JDS Uniphase's auditor, Ernst & Young, was named as a defendant. The complaint alleges that Ernst & Young violated federal securities laws by issuing unqualified audit opinions regarding JDS Uniphase's financial statements that Ernst & Young knew or recklessly failed to discover were false and misleading.

As of August 21, 2002, SEC had taken no regulatory action against JDS Uniphase or any of its officers or directors.

MicroStrategy Incorporated

Business Overview

MicroStrategy Incorporated (MicroStrategy) is a worldwide provider of business intelligence software that enables companies to analyze the raw data stored across their enterprises to reveal the trends and answers needed to manage their business. MicroStrategy's software is used by workgroups, the enterprise and extranet communities via E-mail, Web, wireless and voice communication channels. MicroStrategy also offers services to its customers and partners, including consulting, education, and technical support, accounting for 60 percent of sales. Customers number over 1,700 and include retail, telecommunications, pharmaceutical, insurance, manufacturing, and financial services companies. In business intelligence software, MicroStrategy competes with Microsoft, Oracle, Hyperion Solutions, SAP AG, Computer Associates, and SAS. The company markets its products and services through partners and a direct sales force. MicroStrategy has over 480 technology and integration partners, including IBM, PeopleSoft, and JD Edwards. A slumping economy has led the company to consolidate its operations and cut its workforce by more than one-third. On December 31, 2001, MicroStrategy discontinued the operations of its Strategy.com subsidiary, a personalized information delivery network.

Restatement Data

The Center for Financial Research & Analysis raised questions about certain accounting practices at MicroStrategy in a report issued in November 1999. Specifically, the report raised concerns about MicroStrategy's revenue and earnings figures from an earlier quarter. On March 6, 2000, a *Forbes* magazine article also questioned MicroStrategy's accounting of revenue.[113] After discussions with its senior management, PricewaterhouseCoopers LLP (PwC), MicroStrategy's auditor, recommended that the company issue a restatement. On March 20, 2000, MicroStrategy announced that it intended to restate its financial results for the fiscal years 1998 and 1999. On April 13, 2000, MicroStrategy restated its net income by about $55.8 million for the years 1997, 1998 and 1999. The restatement reduced earnings for those 3 years, from a total net income of about $18.9 million to a net loss of about $36.9 million. In 1997 and 1998, net earnings were reduced by about $1.0 million and $8.4 million, or 831 percent and 137 percent of the amount originally reported, respectively. In 1999, net earnings were reduced by about $46.4 million, or 367 percent of the amount originally reported (table 15).

[113] "MicroStrategy's Curious Success," *Forbes* (March 6, 2000).

Table 15: Selected Financial Data, 1997-1999

(Dollars in thousands)

Affected financial data	Fiscal year 1997	Fiscal year 1998	Fiscal year 1999
Net income, as reported	$121	$6,178	$12,620
Net income (loss), as restated	(885)	(2,255)	(33,743)

Source: SEC filings.

According to the Securities and Exchange Commission (SEC or Commission) order filed in December 2000, the company's reporting failures primarily derived from its premature recognition of revenue from some of its software sales, in violation of The American Institute of Certified Public Accountants (AICPA) Statement of Position (SOP) 97-2, with additional restatements resulting from the company's failure to properly execute contracts in the same fiscal period that revenue was recorded from those deals, as well as other accounting errors.[114] Generally for accounting purposes, product revenue is recognized immediately, while revenue from services is recognized as the services are provided. According to the order, because MicroStrategy's software license sales were part of multiple-element transactions that included other services such as product support and development and consulting, the company was required to apply contract accounting (the subscription method or the percentage of completion method of accounting). However, for a number of transactions that were subsequently restated, MicroStrategy had (1) improperly separated software license sales from their service elements and (2) characterized revenue in multiple element transactions as product or software revenue and recognized it at the time of the transaction.

SEC also alleged that additional accounting errors included the timing of contracts, valuing future obligations, and revenue recognition for barter transactions. In at least three instances, MicroStrategy recognized revenue on transactions that were not completed or signed by either party prior to

[114]Compliance with SOP 97-2 is required by generally accepted accounting principles (GAAP); it provides guidance on whether software license sales revenue can be recognized at the time of sale, or whether it must be recognized with the subscription method or the percentage of completion method of accounting, spreading the recognition of revenue over the entire contract period.

the close of the quarter. In a separate transaction, MicroStrategy improperly recognized revenue for a license to unspecified future products and failed to recognize a deal as a barter transaction yielding no revenue.

In addition to restating its revenue, the company also restated several balance sheet items. This included a reduction of fixed assets by approximately $8.8 million, with approximately $5 million of this as a reduction of revenue, for the fiscal year-end December 31, 1999.

According to SEC's order, one example of the alleged improper use of accounting by MicroStrategy was the handling of a transaction with NCR Corporation (NCR). MicroStrategy signed a final contract for a $27.5 million transaction with NCR in the early hours of October 1, 1999. Although the contract had not been signed by the end of the quarter ended September 30, MicroStrategy improperly recognized $17.5 million in revenue from the transaction in its financial statements for the quarter ended September 30, 1999. NCR, however, did not record the transaction until its fourth quarter. MicroStrategy ultimately restated the NCR transaction due to a misapplication of SOP 97-2. By accounting for the NCR transaction in the third quarter, chief executive officer (CEO) Michael Saylor was able to announce on October 18, 1999, that MicroStrategy had achieved its 15th consecutive quarter of increased revenues. Without the improperly recognized transaction, revenues would have dropped nearly 20 percent from the previous quarter.

Accounting/Audit Firm

PwC assumed its audit role in July 1998 and issued unqualified opinions on MicroStrategy's subsequent financial statements. On January 26, 2000, PwC certified MicroStrategy's 1999 financial statements. After public scrutiny of third quarter results by the Center for Financial Research & Analysis and *Forbes* magazine, PwC recommended that MicroStrategy restate its financial statements in March 2000. Later that year, SEC began investigating the relationship between PwC and MicroStrategy. Specifically, SEC investigated PwC's purchase of MicroStrategy products for resale to its consulting clients. According to Microstrategy, SEC's investigation is still ongoing. To date, PwC has not been charged in this matter. On July 7, 2000, PwC was named as a defendant in a consolidated class-action lawsuit filed against MicroStrategy, its officers and directors. See the "Legal and Regulatory Actions" section of this case study.

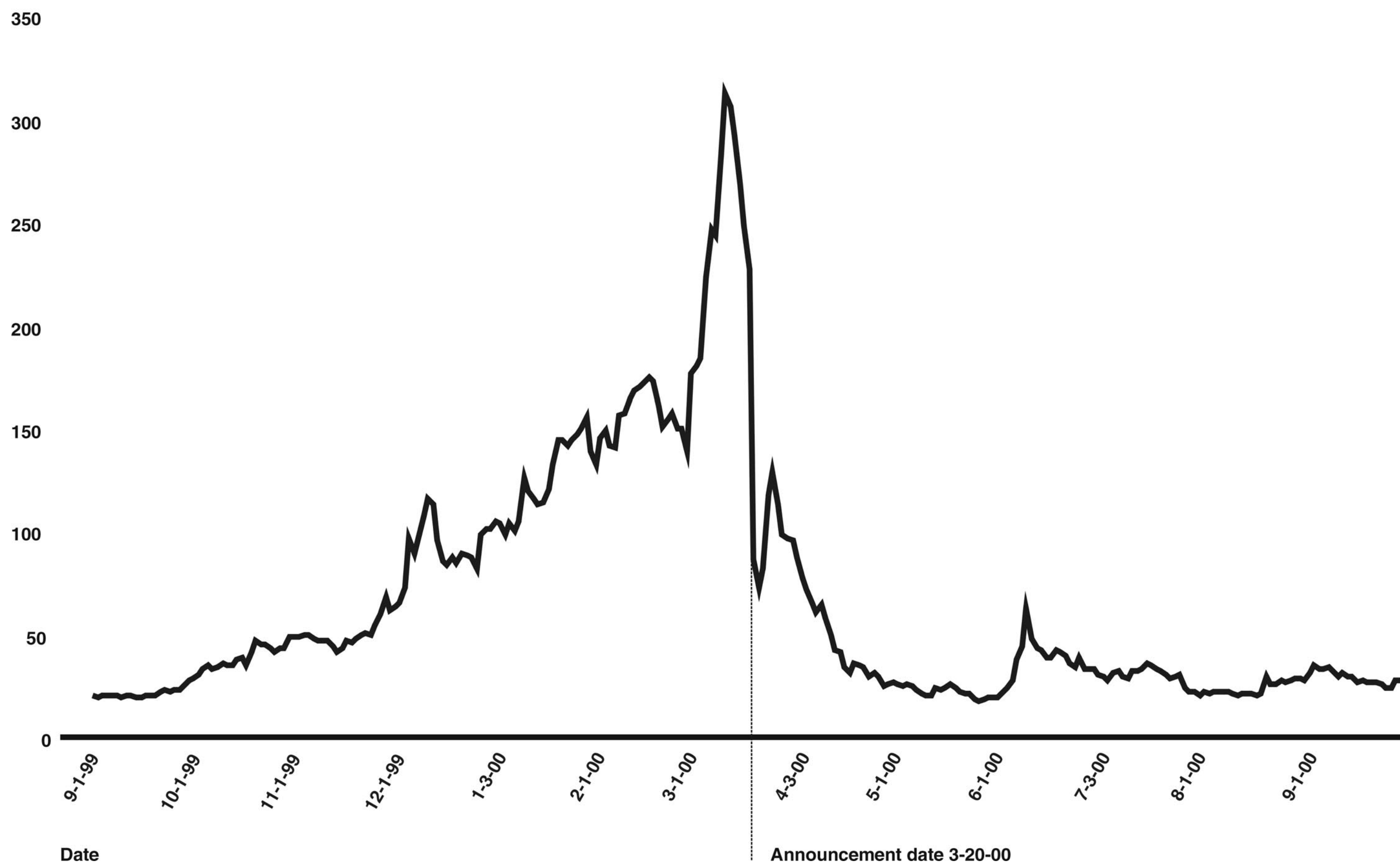
Stock Price

MicroStrategy stock trades on the National Association of Securities Dealers Automated Quotation (Nasdaq) under the ticker symbol MSTR. Even after questions were raised about MicroStrategy's accounting practices, its stock price continued to increase dramatically. From the time that the Center for Financial Research & Analysis first raised concern on November 11, 1999, to the *Forbes* article on March 6, 2000, the stock price increased over 400 percent. On January 27, 2000, after MicroStrategy announced fourth quarter results, the stock price closed at $149.56 per share.[115] The stock price continued to climb and doubled between the end of February and March 10, 2000, when the stock price closed at $313. On the last trading day before MicroStrategy announced its intended restatement, MicroStrategy's stock price closed at $226.75 per share. On March 20, 2000, when MicroStrategy announced that its financial statements for the past 2 years would need to be restated, the stock price fell over 60 percent to close at $86.75. The stock price continued to fall the day after the announcement and closed at $72.31. Over these 3 trading days, the stock price fell almost 70 percent. By the time MicroStrategy filed its restated financial statements with SEC on April 13, 2000, the stock price closed at $39.06. On July 25, 2002, the stock price closed at $0.47. On September 17, 2002, the stock price closed at $10.29.[116]

[115]On January 26, 2000, MicroStrategy implemented a 2:1 stock split of its common stock.

[116]On July 30, 2002, MicroStrategy implemented a 1:10 reverse stock split of its common stock.

Figure 18: Daily Stock Prices for MicroStrategy, September 1, 1999–September 29, 2000



Note: Stock prices have been adjusted to account for the January 26, 2000, 2:1 stock split.

Source: GAO's analysis of NYSE TAQ data.

Securities Analysts' Recommendations

Based on historical securities analysts' research we found, in early 2000, as MicroStrategy's stock price increased, analysts promoted the stock. For example, on January 12, 2000, one firm reiterated its strong buy recommendation, while another reiterated its buy recommendation on January 28, 2000. While a number of firms downgraded their recommendations after the March 20, 2000, restatement announcement,

the downgrades ranged from accumulate to hold. For example, on March 20, 2000, one firm downgraded MicroStrategy from near-term/long-term buy to near-term/long-term accumulate while three other firms downgraded from strong buy and long-term buy to accumulate and hold, respectively, on April 27, 2000.

Credit Rating Agency Actions

No information was found.

Legal and Regulatory Actions Taken

From March 2000 through May 2000, 25 class-action complaints were filed against MicroStrategy and certain of its officers and directors alleging violations of Section 10(b), Rule 10b-5 thereunder, Section 20(a) and Section 20A of the Securities Exchange Act of 1934 (Exchange Act). The company's auditor, PwC, was also named in two of the suits. The complaints contained varying allegations, including that MicroStrategy made materially false and misleading statements regarding the company's 1997, 1998, and 1999 financial results in filings with SEC, analysts' reports, press releases and media reports. These class-action lawsuits were consolidated and a settlement agreement was later reached on October 23, 2000. The class members were entitled to receive (1) an aggregate principal amount of $80.3 million of MicroStrategy's 7.5 percent series A unsecured notes, which have a 5-year maturity and bear interest at 7.5 percent per year, payable semiannually; (2) 297,330 shares of class A common stock; (3) warrants to purchase 189,698 shares of class A common stock at an exercise price of $400.00 per share, with the warrants expiring on June 24, 2007; and (4) approximately $5,000 in cash to settle remaining fractional interests. On June 24, 2002, all of the common stock, warrants and cash were issued to the class members. The company issued 1 percent of the aggregate principal amount of the promissory notes on June 24, 2002, and issued the remaining 99 percent of the aggregate principal amount of the promissory notes on July 2, 2002. PwC also settled its class-action lawsuit in connection with the restatement of MicroStrategy's financial statements with a $55 million cash payment.

On June 30, 2000, a shareholder derivative action was filed in the Delaware Court of Chancery seeking recovery for various alleged breaches of fiduciary duties by certain of the company's directors and officers relating to its restatement of financial results. Subsequently, Microstrategy and the

directors and officers named as defendants settled this action. Under the settlement, MicroStrategy added two new independent directors with finance experience to the audit committee of its board of directors and will ensure continued adherence with applicable legal and regulatory requirements regarding the independence of audit committee members and trading by insiders. On November 7, 2001, as a part of the derivative settlement agreement and in satisfaction of a condition to the distribution of the securities issued as part of the class-action settlement, Mr. Saylor, chairman of the board of directors and CEO; Mr. Bansal, vice chairman, executive vice president and chief operating officer (COO); and Mr. Lynch, former chief financial officer (CFO) and current vice president of business affairs, tendered to MicroStrategy for cancellation an aggregate of 168,350 shares of class A common stock held by them.

In March 2000, SEC issued a formal order of investigation of MicroStrategy relating to the company's restatement of revenue and earnings. On December 14, 2000, this investigation resulted in SEC's initiation and settlement of administrative reporting charges against MicroStrategy and accounting fraud charges against its Mr. Saylor, CEO; Sanju K. Bansal, COO; and Mark S. Lynch, former CFO.

The charges against the company were instituted through entry of an order instituting proceedings pursuant to Section 21C of the Exchange Act, making findings, and imposing remedial sanctions and a cease and desist order. SEC found that MicroStrategy violated Sections 13(a), 13(b)(2)(A), and 13(b)(2)(B) of the Exchange Act and Rules 13a-1 and 13a-13 thereunder, relating to the filing of annual and quarterly reports, the recording of transactions, and the maintenance of accurate books and records. The company consented to this order and agreed to significant undertakings in the areas of corporate governance, management, and compliance in order to strengthen the company's financial reporting and accounting processes.

The action against MicroStrategy's top three officers alleged that they materially overstated MicroStrategy's revenues and earnings from the time of its initial public offering in June 1998 through March 2000. SEC alleged that Mr. Lynch, the CFO, was principally responsible for ensuring the veracity of MicroStrategy's financial reporting and signed the company' periodic reports. Mr. Saylor, the CEO, signed the periodic reports and participated in the negotiation of several of the largest restated transactions. Mr. Bansal, the COO, also participated in the negotiation of several of the restated transactions and signed numerous contracts on

which revenue was improperly recognized. Without admitting or denying the allegations, these company officers consented to the entry of a final judgment permanently enjoining each of them from violating the antifraud and recordkeeping provisions of the federal securities laws (Section 17(a) of the Securities Act of 1933, Section 10(b) of the Exchange Act and Rules 10b-5 and 13b2-1 thereunder). These officers further agreed to disgorge a total of approximately $10 million and pay civil penalties of $350,000 each. Mr. Lynch also consented to the entry of an administrative order pursuant to SEC Rule 102(e)(3), based on entry of an injunction, barring him from practicing before SEC as an accountant, with a right to reapply after 3 years. SEC also instituted a settled order against Antoinette A. Parsons, MicroStrategy's corporate controller, and Stacy L. Hamm, the accounting manager, in which each consented to the entry of a cease and desist order for reporting and recordkeeping violations.

Orbital Sciences Corporation

Business Overview

Orbital Sciences Corporation (Orbital) is a space technology company that designs, manufactures, operates, and markets a broad range of space-related systems for commercial, government and military customers. Orbital's products include low-level orbit, geosynchronous orbit, and planetary spacecraft used for communications, remote sensing, and scientific purposes. The company also provides launch services used to place satellites into orbit and suborbital launch vehicles and missile defense boosters that are used as interceptor and target vehicles in missile defense systems. The U.S. government and its contractors account for about 55 percent of Orbital's 2001 sales. For the 6 months ending June 30, 2002, revenues rose 26 percent to $256.1 million. Net income from continuing operations totaled $7.8 million for the 6 months ended June 30, 2002, versus a net loss of $47.8 million for the comparable 2001 period.

Restatement Data

During 1999 and 2000, Orbital made a number of announcements regarding various determinations to restate its financial statements. Initially, on February 16, 1999, Orbital announced that the company would restate its financial statements for the first three quarters of 1998, based upon recommendations made by its independent auditors, KPMG LLP. The company indicated that it did not agree with such recommendations, which related primarily to the accounting treatment of certain capitalized costs and revenue recognition. On April 29, 1999, the company fired KPMG LLP due to disagreements with regard to, among other things, the above-described accounting issues. Orbital engaged PricewaterhouseCoopers LLP (PwC) as its new independent auditor.

On October 29, 1999, Orbital announced that based on a recommendation by PwC, the company would change its previously audited accounting treatment primarily with respect to its investment in an affiliate. While KPMG LLP had previously reviewed and approved the company's prior accounting treatment, when the issue was raised by PwC, KPMG LLP informed the company that KPMG LLP had changed its position and the company's financial statements should be restated for fiscal years ended December 31, 1997, and 1998.

On March 30, 2000, Orbital announced that the issuance of its final audited financial statements for the quarter and year ended December 31, 1999, would be delayed due to a disagreement between its current and previous auditors on whether previously capitalized costs related to the company's two principal space launch vehicles should be expensed. The third

restatement announcement occurred on April 14, 2000. The company announced that based on the recommendation of its current auditors, PwC, Orbital determined that it would also restate its financial statements for the years ended December 31, 1995, and 1996, in order to expense costs related to the company's two principal space launch vehicles that were previously capitalized. The company also announced that it was continuing to work with its current and previous auditors to finalize the previously announced restatements for 1997, 1998, and the first three quarters of 1999.

On April 17 and April 19, 2000, the company released its restated 1998 to 1999 and 1995 to 1997 financial results. Subsequently, the company filed a series of amendments to its 1995 to 1998 Form 10-Ks and related Form 10-Qs, including the first three quarters of 1999 (table 16).

Table 16: Selected Financial Data 1995–1999

(Dollars in thousands)

Affected financial data	Fiscal year 1995	Fiscal year 1996	Fiscal year 1997	Fiscal year 1998	First quarter 1999	Second quarter 1999	Third quarter 1999
Net income (loss), as reported	$(4,848)	$15,907	$23,005	$(6,372)	$(15,871)	$(10,149)	$(32,649)
Net income (loss), as restated	(5,590)	9,942	(11,405)	(56,552)	(26,163)	(26,071)	(39,566)

Source: SEC filings.

Accounting/Audit Firm

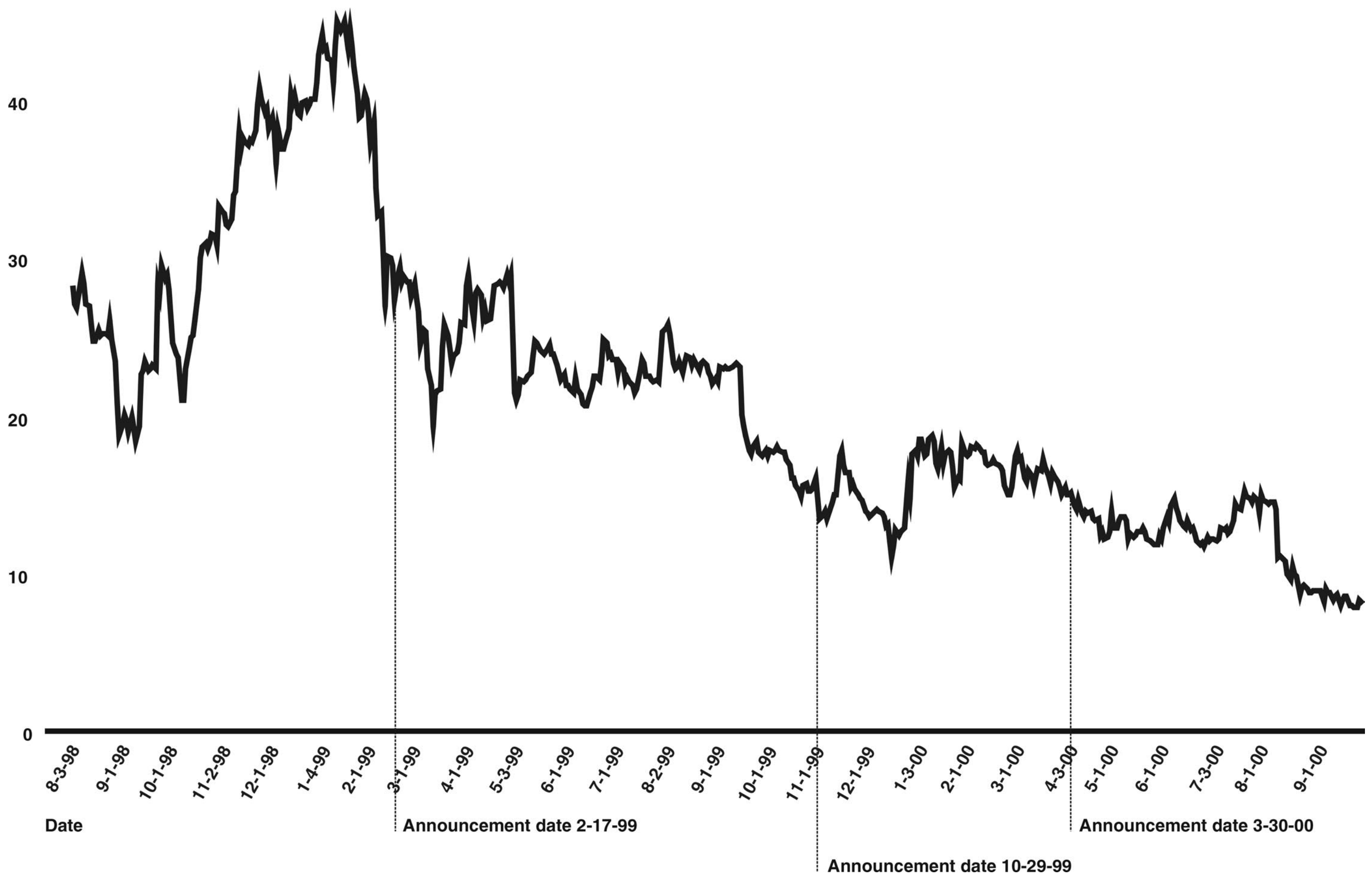
During the periods that were eventually restated, KPMG LLP was Orbital's independent accountant. Orbital fired KPMG LLP on April 29, 1999, after Orbital and KPMG LLP were unable to agree on the interpretation and application of various accounting standards. KPMG LLP had advised the company that it believed there were material weaknesses in certain of Orbital's internal control systems. Press sources noted although KPMG LLP initially signed off on Orbital's financial statements for the periods concerned, KPMG LLP documented their issues with the firm in a May 14, 1999, letter to the Securities and Exchange Commission (SEC) and in a confidential letter to the audit committee of Orbital's board of directors. Subsequently, Orbital hired PwC, which advised Orbital in October 1999 to restate its financial statements for the years 1997, 1998, and part of 1999 due to questionable accounting treatment with respect to its investment in an affiliate, Orbital Imaging Corporation. KPMG LLP concurred with these

restatements. Additionally, Orbital restated 1995 and 1996 financial results as a result of a change in how it accounted for product enhancement costs.

Stock Price

Orbital's stock is traded on the New York Stock Exchange (NYSE) under the ticker symbol ORB. The stock peaked at over $45 per share in mid-January 1999 (Fig. 19). A sharp decline ensued following an earnings warning from the company on February 4, 1999, in which Orbital said that accounting changes at two of its units would cause it to miss earnings estimates. The stock closed at $29.625 on February 16, 1999, and after the close of trading the company reported its fiscal fourth quarter numbers—which were far below analyst estimates—and announced a restatement. On February 17, 1999, Orbital shares fell $2.25 (8 percent) to $27.375. Later, after reporting a large fiscal first-quarter loss and announcing a change of auditors on April 29,1999, Orbital's stock declined over 25 percent. Then, in mid-September 1999, a brokerage firm lowered its third-quarter estimates for Orbital; the stock dropped from over $23 to the mid-teens by late October 1999. On October 29, 1999, the date that Orbital announced that it would need to restate back to 1997, its stock fell slightly. On March 30 and April 14, 2000, Orbital issued announcements regarding delays in the release of financial statements as a result of deciding to restate additional years. Finally, beginning in April 2000 Orbital began to release its restated numbers. The stream of earnings disappointments and accounting problems contributed to the stock moving from over $40 in early 1999 to under $10 in late 2000. Over the same period the stock market increased over 20 percent.

Figure 19: Daily Stock Prices for Orbital, August 3, 1998–September 29, 2000



Source: GAO's analysis of NYSE Trade and Quote data.

Securities Analysts' Recommendations

Based on historical analyst research we were able to find, at least 11 firms covered Orbital. All maintained recommendations ranging from hold to buy. Of the firms that took action in 1999 and 2000, half downgraded their recommendations. For example, on August 9, 2000, one firm downgraded the stock from a strong buy to a buy, based primarily on Orbital's second-quarter 2000 performance. Another firm stated that despite the troubles with Orbital's affiliate Orbcomm, which Orbital had written off, it rated the

company as an outperform with a $17 price target. At that time, the stock was trading at $9.63 (August 16, 2000).

Credit Rating Agency Actions

Moody's Investors Service, Inc. (Moody's) and Standard and Poor's rated Orbital's debt. In 1998 Moody's credit rating for Orbital's debt indicated that it generally lacked the characteristics of a desired investment and assurance that interest and principal payments over any long period may be small. Standard and Poor's rating was slightly higher, indicating that it faced major ongoing uncertainties and exposure to adverse business, financial, or economic conditions, which could affect its capacity to meet its financial commitments. In June 1999, Moody's downgraded Orbital's debt rating to poor. In November 1999, after the October restatement announcement, Standard and Poor's lowered Orbital's credit rating as well. In May 2000, Standard and Poor's reaffirmed its rating.

Legal and Regulatory Actions Taken

In the first quarter of 1999, several lawsuits were filed by investors on behalf of shareholders against Orbital and KPMG LLP. The lawsuits related to, among other things, matters underlying the restatements announced in February 1999. These lawsuits were eventually consolidated into a class-action lawsuit. In the fourth quarter of 1999, in connection with the company's October 1999 restatement announcement, another class-action lawsuit was filed against Orbital. According to Orbital, the consolidated class-action lawsuits were settled. Under the settlement, Orbital's insurance carrier was to pay $11 million to the shareholder class. In addition, Orbital was to issue warrants having an aggregate fair value of $11.5 million as of the settlement date. The proposed settlement of the class- action lawsuit against KPMG LLP required KPMG LLP to pay $1 million in cash.

SEC filed an amicus curaie—friend of the court brief—related to motions filed with the court regarding the appointment of lead plaintiff in the shareholder actions. However, to date, SEC has not pursued any legal or administrative proceedings against the company related to securities violations.

Rite Aid Corporation

Business Overview

Rite Aid Corporation (Rite Aid) is the third largest retail drugstore chain in the United States, operating nearly 3,500 retail drugstores in 28 states and the District of Columbia. Rite Aid sells prescription drugs—accounting for about 60 percent of sales—nonprescription medications, health and beauty aids, personal care items, cosmetics, photo processing and convenience items. In July 1999, Rite Aid partnered with the Internet pharmacy drugstore.com with an approximately 22 percent equity investment, which has since been sold. During the 1990s, Rite Aid expanded through a number of acquisitions, including Perry Drug Stores in fiscal year 1995; Thrifty PayLess Holdings, Inc., (Thrifty PayLess) in fiscal year 1996; Harco Inc., (Harco); and K&B Inc., (K&B), in fiscal year 1997; and PCS Health Systems Inc., (PCS) in fiscal year 1999. In order to reduce debt, Rite Aid sold the health care provider PCS to Advance Paradigm in October 2000.

Restatement Data

On June 1, 1999, Rite Aid filed its Form 10-K with the Securities and Exchange Commission (SEC or Commission), which included its financial statements for fiscal year ended February 27, 1999. This filing also contained restatements of Rite Aid's prior financial statements for fiscal years 1997 and 1998, and the interim periods for 1998 and 1999. According to the filing, the restatement followed discussions between Rite Aid and SEC concerning an SEC review of a filed registration statement. On October 11, 1999, following further discussions with SEC, Rite Aid announced that it would again restate previously reported interim and annual financial statements for 1997, 1998, and 1999.

On October 18, 1999, Martin L. Grass resigned his positions as chairman of the board and chief executive officer (CEO) of Rite Aid. Frank Bergonzi, who had previously stepped down as the company's chief financial officer (CFO), also left the company. On November 11, 1999, KPMG LLP resigned as Rite Aid's auditor and withdrew its report on the company's consolidated financial statements for the 3-year period ended February 27, 1999, stating that it was unable to continue to rely on management's representations.

In its quarterly report for the second quarter of fiscal year 2000, filed on November 2, 1999, Rite Aid restated its previously reported financial statements for the first two quarters of fiscal year 1999 and the first quarter of fiscal year 2000. In that filing, Rite Aid indicated that additional adjustments to its financial statements might be necessary.

According to Rite Aid's filing with SEC, on December 5, 1999, Rite Aid hired a new executive management team that started a process to resolve the company's financial reporting issues. Rite Aid's new management team reevaluated the accounting issues identified before December 1999 as well as an investigation and restatement for 1998, 1999, and the first two quarters of 2000. According to Rite Aid, after the new management team arrived, it (1) hired a new auditor; (2) engaged a law firm, through the audit committee of the board, to conduct an investigation of its reporting and accounting practices with the assistance of Deloitte & Touche LLP; (3) decided not to file additional reports with SEC until the new audit was complete; (4) retained Arthur Andersen LLP to assist with reconciling the books; and (5) began to develop a plan to strengthen the company's internal controls. Rite Aid filed the result of this review with SEC on July 11, 2000, which included restatements for 1998, 1999, and part of 2000. The aggregate affect of these adjustments was to reduce net income by $492 million and $566 million for fiscal 1998 and 1999, respectively. Likewise, the adjustments for 1998 and 1999 reduced retained earnings by $1.6 billion. Rite Aid did not restate 1996 and 1997 financial statements because it believed that it would require unreasonable cost and expense. However, the company reported that the financial data for 1997 and 1996 should not be relied upon.

According to SEC's complaint filed against the company, Rite Aid's misstated financials were due to widespread errors resulting from faulty, inappropriate, and misleading accounting practices. Rite Aid listed its major adjustments to correct these practices as follows:

- Adjustments to inventory and cost of goods sold included correcting unearned vendor allowances previously recorded as a reduction to cost of goods sold, correctly applying the retail method of accounting, recording write downs for slow moving and obsolete inventory, recognizing certain selling costs including promotional markdowns and shrink in the period in which they were incurred, accruing for inventory cutoff, and reflecting unearned vendor allowances in the inventory balances. For example, for those vendors that did not require Rite Aid to return damaged and outdated products, Rite Aid had the products destroyed and reported to the vendor the quantity and dollar value of the destroyed product and deducted the value of the destroyed products from a future remittance to the vendor. Rite Aid allegedly inflated these values.

- Rite Aid also failed to expense the cost of the company's stock appreciation rights program.

- Adjustments to property, plant, and equipment that were previously capitalized to expense them in the period in which they were incurred. The items include certain costs for repairs and maintenance, interest, and internal software expenditures. The adjustments also include increases to depreciation expense to reverse the effects of retroactive changes made to the useful lives of certain assets, to depreciate assets misclassified as construction in progress and to recognize depreciation expense in the appropriate periods.

- Adjustments to lease obligations to reflect the sale leaseback of certain stores as financing transactions. Such transactions had previously been accounted for as sales with corresponding operating leases. The adjustment to correct these items resulted in the reversal of the asset sales and the establishment of lease obligations. In addition, certain leases previously accounted for as operating leases, were determined to be capital leases.

- Adjustments for liabilities associated with Rite Aid's acquisition of Thrifty PayLess in fiscal 1997 and Harco and K&B in fiscal 1998. Certain liabilities associated with these acquisitions that had previously been established with a corresponding increase to goodwill have either been reduced or eliminated to correctly reflect the fair value of the assets and liabilities acquired at the date of acquisition.

- Adjustments to expense certain operating costs in the period in which they were incurred and to record a corresponding liability for those items not paid at the end of the period. Such costs primarily consisted of payroll, vacation pay, incentive compensation, executive retirement plans, scheduled rent increases, and certain insurance claims.

- Adjustments to appropriately recognize charges related to store closures in the period in which the decision, and ability, to close a store was made. In addition, other charges not related to exiting stores and gains from the sale of certain assets that had previously been recorded as adjustments to the store exit liability were reflected as income or expense in the period in which they were incurred or realized.

After filing the 2000 Form 10-K, Rite Aid initiated the process of posting the $1.6 billion of restatement adjustments previously reported to the

company's detailed books and records for each of the periods involved. Subsequently, Rite Aid identified errors that had been made when processing the restatement adjustments that affected the restated results for all annual and quarterly reports in the company's 2000 Form 10-K. As a result, additional adjustments having a cumulative effect of $1.6 million on retained earnings on February 26, 2000, were made to the financial statements for fiscal years 1998, 1999, and 2000. Despite the relatively small size of these adjustments, Rite Aid further restated the financial statements covered in the July 11, 2000, restatement in an amended Form 10-K filed October 11, 2000. The restatement decreased Rite Aid's previously reported net loss for the fiscal year 2000 by $10 million, increased the net loss by $39 million for fiscal year 1999, and decreased the net loss for 1998 by $21 million. This resulted in restated net losses of $1.1 billion, $461.5 million, and $165.2 million, respectively (table 17).

Table 17: Selected Financial Data, 1997-2000

Dollars in millions

Affected financial data	Fiscal year 1997	Fiscal year 1998	Fiscal year 1999	Fiscal year 2000
Net income (loss), as reported	$115	$316	$144	($1,143)
Net income (loss), as restated in June 1999	117	306	N/A	N/A
Net income (loss), as restated in July 2000	N/A	(186)	(423)	N/A
Net (loss), as restated in October 2000	N/A	(165)	(462)	(1,133)

Note: N/A means not applicable.

Source: SEC filings.

Accounting/Audit Firm

KPMG LLP was Rite Aid's independent auditor for fiscal years 1998 and 1999. KPMG LLP played a role in Rite Aid's June 1, 1999, restatement. At a meeting of Rite Aid's audit committee, on June 30, 1999, KPMG LLP delivered a letter to the audit committee dated June 24, 1999, that described a number of material weaknesses in Rite Aid's internal controls. The letter

stated that Rite Aid's internal controls were insufficient to allow the company's management "to accumulate and reconcile information necessary to properly record and analyze transactions on a timely basis." The letter also suggested a number of actions to improve the quality of Rite Aid's financial accounting and reporting functions. KPMG LLP recounted that it informed Rite Aid on June 23, 1999, and the audit committee at the June 30, 1999, meeting that, as a result of the issuance of the material weakness letter, KPMG LLP would not be in a position to issue quarterly review reports until the matters it raised were addressed and resolved. KPMG LLP also asserted that it was no longer willing to rely on representations made by the serving CFO at that time. The members of Rite Aid's audit committee and another member of the company's board of directors who attended the June 30, 1999, meeting deny that any such statements were made, while KPMG LLP strongly stands behind its recollection of the meeting. Subsequent to the meeting, Rite Aid says that actions were taken to evaluate system needs in order to improve its financial reporting system. On December 5, 1999, Rite Aid's CFO was replaced. On November 11, 1999, KPMG LLP resigned as auditor of Rite Aid because it was unable to rely on management's representations. KPMG LLP also withdrew its auditor's report dated May 28, 1999, of Rite Aid's financial statements. The withdrawn report and KPMG LLP's report on Rite Aid's financial statements for the fiscal year ended February 28, 1998, did not contain an adverse opinion or a disclaimer of opinion and were not qualified or modified as to uncertainty, audit scope, or accounting principles. However, SEC has alleged in a complaint dated June 21, 2002, that Rite Aid's CEO provided, and directed his staff to provide, false and misleading information to KPMG LLP. The false information included, among other things, Rite Aid's books and records, unaudited financial statements, and bank records.

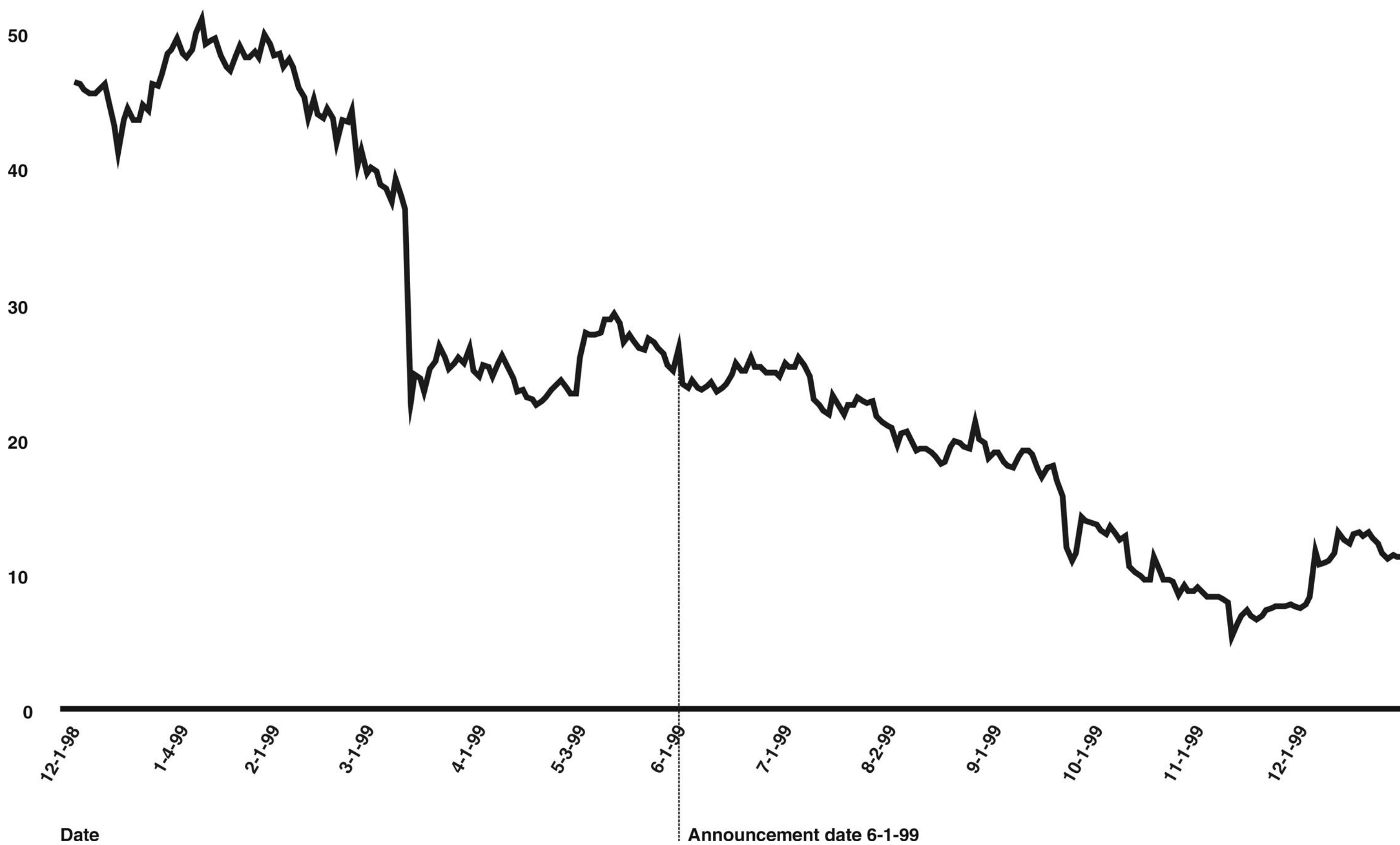
Rite Aid subsequently hired Deloitte & Touche LLP as its independent auditor.

Stock Price

Rite Aid stock trades on the New York Stock Exchange (NYSE) under the ticker symbol RAD. In early 1999, Rite Aid's stock traded between $40 and $50 per share. However, on March 12, 1999, Rite Aid announced its fourth-quarter results, which were below analysts' estimates, and its stock price dropped almost 40 percent from a closing price of $37.00 on March 11, 1999, to $22.56 the following day (fig. 20). On June 1, 1999, when Rite Aid announced that it had restated 3 previous years of earnings, the stock price closed at $26.69. The following day, June 2, 1999, the stock price closed at

$24.50. By October 11, 1999, when Rite Aid announced that it would once again restate its 1997 through 1999 earnings, its stock price closed at $10. Around this time Rite Aid also announced that it would not be able to file its Form 10-Q on time. Overall, Rite Aid's stock price fell almost 60 percent from June to October and continued to fall for most of the balance of 1999. The stock price finished 1999 at slightly above $11. On July 11, 2000, when Rite Aid filed its Form 10-K with SEC, which included restated financial statements for the previously restated periods, its stock closed at $6.62, down over 20 percent from $8.38 the day before the restatement; the day after the restatement, the stock slipped to $6 (a drop of almost 30 percent over the 3 days). The stock price continued to decline, and when Rite Aid filed its amended annual report in October 2000, its stock price closed at $3.06.

Figure 20: Daily Stock Prices for Rite Aid, December 1, 1998–December 31, 1999



Source: GAO's analysis of NYSE Trade and Quote data.

Securities Analysts' Recommendations

Based on available historical information on securities analysts' recommendations, we identified eight firms that covered Rite Aid during the relevant period. Although analysts use a variety of recommendations to indicate whether to buy or sell securities, one rated it as a hold and the other rated it as near-term neutral. Even on the news that Rite Aid had restated its 1997, 1998, and 1999 financials for a fourth time, one firm upgraded its recommendation in 2000. Recommendations on Rite Aid's

stock have continued to vary, with some analysts downgrading their recommendations and others upgrading them.

Credit Rating Agency Actions

Rite Aid's debt is rated by Moody's Investors Service, Inc. (Moody's) and Standard and Poor's rating agencies. Moody's and Standard and Poor's began to lower Rite Aid's credit rating in 1995 and made several rating actions over the next several years. In 1996 and 1998, Moody's confirmed Rite Aid's debt, which indicated that its debt offered adequate financial security while Standard and Poor's took no action. In June 1999, 3 days after the restatement of its 1997 to 1999 financial statements, Moody's confirmed Rite Aid's rating but changed its outlook to negative, while on June 14, 1999, almost 2 weeks after the June 1, 1999, restatement, Standard and Poor's lowered its rating. In September 1999, the month before the revised restatement, Moody's placed Rite Aid's rating on review for possible downgrade. On October 1, 1999, a week before the restatement of the previously restated financial statements, Moody's downgraded Rite Aid's rating, indicating that certain protective elements might be lacking over time, and rated its outlook as negative. Standard and Poor's took similar action days before the October 11, 1999, restatement. Within weeks, Moody's and Standard and Poor's downgraded Rite Aid's debt again indicating that its long-term debt was of questionable financial security and maintained their negative outlook. One month later, Moody's lowered Rite Aid's rating again indicating that it offered poor financial security and the outlook remained negative. In 2000, Moody's and Standard and Poor's downgraded Rite Aid's rating even further.

Legal and Regulatory Actions Taken

On March 15, 1999, a securities class-action lawsuit was filed against Rite Aid, its directors, officers, and outside auditor, KPMG LLP. Rite Aid was accused of making materially false and misleading statements and artificially inflating the price of Rite Aid's common stock. In November 2001, Rite Aid agreed to pay $45 million in cash and about $150 million in stock to its shareholders to settle the suit. Although shareholders settled with the company, there are still outstanding civil cases against KPMG LLP, Mr. Martin L . Grass and Mr. Frank M. Bergonzi.

According to Rite Aid's filings with SEC, in November 1999, SEC began a formal investigation of Rite Aid's financial statements after Rite Aid restated its earnings twice for the 3 prior fiscal years. On June 21, 2002, SEC announced that it had settled with Rite Aid and Timothy J. Noonan, its

former president and chief operating officer (COO). Neither Rite Aid nor Mr. Noonan admitted nor denied SEC's findings. According to the cease-and-desist order, SEC alleged that Rite Aid's former management team engaged in financial fraud that materially overstated the company's net income for fiscal years 1998, 1999, and the first quarter of 2000. SEC further alleged that Rite Aid's former senior management failed to disclose material information, including related-party transactions, in proxy and registration statements, and a Form 8-K filed in February 1999.

SEC alleged that Rite Aid violated the reporting, books and records, and internal controls provisions of the Securities Exchange Act of 1934 (Exchange Act). According to SEC, Rite Aid's internal books, records, and accounts reflected numerous transactions that were invalid or without substantiation, had no legitimate business purpose, and were recorded in violation of generally accepted accounting principles (GAAP). Moreover, SEC charged that from at least 1997 to July 11, 2000, all of the annual and quarterly reports that Rite Aid filed with SEC contained misleading financial statements. As a result, Rite Aid violated Sections 13(a) and 13(b)(2)(A) of the Exchange Act and Rules 12b-20, 13a-1, and 13a-13 thereunder. SEC further alleged that Rite Aid's system of internal accounting controls was not designed to provide reasonable assurances that transactions were recorded as necessary to permit preparation of financial statements in conformity with GAAP or to maintain the accountability of assets; hence, Rite Aid's system of internal accounting controls failed to prevent, and facilitated, the improper accounting practices described above. As a result, SEC charged that Rite Aid violated Section 13(b) of the Exchange Act and Rule 13(b)(2)(B) thereunder.

SEC also settled its cease-and-desist proceeding against Mr. Noonan, a director, president, and COO of Rite Aid from March 1995 to December 1999 and interim CEO from October 15, 1999 through December 5, 1999. SEC alleged that Mr. Noonan participated in activities that caused Rite Aid to overstate its net income by, among other things, understating its vendor accounts payable and cost of goods sold. The order alleged that Mr. Noonan was aware that Rite Aid improperly inflated the quantities and dollar value of damaged and outdated products reported to vendors that did not require Rite Aid to return these products to them. In addition, SEC alleges Rite Aid falsely reported price markdowns as damaged and outdated products. The vendors did not agree to the charges and were misled into believing that the deductions taken by Rite Aid in February 1999 were for damaged and outdated products. According to the order, Mr. Noonan participated in activities that caused Rite Aid to process these

unauthorized markdowns. Based on these activities, SEC charged that Mr. Noonan committed or caused violations of Sections 10(b) of the Exchange Act and Rule 10b-5 thereunder, and caused violations by Rite Aid of Sections 13(a) and 13(b)(2) of the Exchange Act and Rules 12b-20, 13a-1, and 13a-13 thereunder. Based on the cooperation extended to SEC, SEC deemed it appropriate to issue a cease-and-desist order.

In June 2002, SEC filed a separate complaint against Mr. Bergonzi, Rite Aid's CFO from March 1995 to January 1999; Franklin C. Brown, executive vice president and chief legal counsel from April 1993 to July 1997 (served as vice chairman of the board until May 2000); and Mr. Grass, CEO and chairman of the board from March 1995 until his resignation on October 18, 1999. According to the complaint, Messrs. Bergonzi, Brown, and Grass were controlling persons of Rite Aid for the purposes of Section 20(a) of the Exchange Act. According to SEC's complaint, Messrs. Bergonzi, Brown, and Grass received ill-gotten gains in the form of performance-related cash bonuses totaling more than $1.5 million

The SEC complaint alleged that at the direction of Mr. Bergonzi, Rite Aid's accounting staff recorded numerous and varied types of accounting entries that had no basis or false substantiation and/or were in violation of GAAP. SEC stated that these transactions were generally made at the end of or just after a quarterly or yearly period. SEC charged all three with financial fraud, fraudulent periodic reports and registration statements; fraudulent proxy statements and press releases; fraudulent misrepresentations in connection with stock pledges (violations of Section 17(a) of the Securities Act of 1933, and Section 10(b) of the Exchange Act, and Rule 10(b)-5 thereunder); falsification of corporate books and records and circumvention of internal controls (violations of Section 13(b)(5) of the Exchange Act, and Rule 13b2-1 thereunder); misrepresentations to accountants (violations of Exchange Act Rule 13b2-2, 17 C.F.R. §240.13b2-2); periodic reporting violations (violations of Sections 13(a) of the Exchange Act, and Rules 12b-20 and 13a-1, thereunder); and corporate recordkeeping and internal control violations (Section 13(b)(2) of the Exchange Act). Mr. Bergonzi was also charged as a controlling person with quarterly reporting violations (violations of Section 13(a) of the Exchange Act, and Rules 12b-20 and 13a-13, thereunder). Mr. Grass and Mr. Brown, as controlling persons of Rite Aid, were also charged with current reporting violations and proxy statement violations (Sections 13(a) of the Exchange Act, and Rules 12b-20 and 13a-11 thereunder), and Section 14(a) of the Exchange Act, and Rule 14a-9(a) thereunder.

SEC is seeking against Messrs. Bergonzi, Brown, and Grass a permanent injunction, disgorgement of ill-gotten gains, civil money penalties, and officer and director bars.

The U.S. Attorney of the Middle District of Pennsylvania also announced related criminal charges against Messrs. Bergonzi, Brown, and Grass including mail fraud, wire fraud, conspiracy and lying to SEC.

Safety-Kleen Corporation

Business Overview

Safety-Kleen Corporation (Safety-Kleen) is an industrial and hazardous waste management company in North America. The company provides a range of services designed to collect, transport, process, recycle, or dispose of hazardous and nonhazardous industrial and commercial waste. As of May 1, 2001, the company had over 9,600 employees.

On June 9, 2000, Safety-Kleen and 73 of its domestic subsidiaries voluntarily filed for protection under Chapter 11 of the U.S. Bankruptcy Code. Safety-Kleen is in the process of reorganizing.

Restatement Data

According to Safety-Kleen's filings with the Securities and Exchange Commission (SEC or Commission), on March 6, 2000, Safety-Kleen's board of directors received information alleging possible accounting irregularities that may have affected previously reported financial results. On March 6, 2000, the company announced that it had initiated an internal investigation of its previously reported results and certain of its accounting policies and practices. Specifically, the investigation focused on accounting irregularities, including improper revenue recognition, inappropriate recognition of gain on derivatives transactions, inappropriate capitalization of costs, and insufficient liability accruals. The board's independent directors headed the effort and hired Shaw Pittman and Arthur Andersen LLP to conduct the investigation. The investigation ultimately led to the July 9, 2001, restatement of previously reported earnings for fiscal years 1997 through 1999, which decreased its previously reported earnings by $534 million (table 18).

Table 18: Selected Financial Results, 1997–1999

Dollars in millions

Affected financial data	Fiscal year 1997	Fiscal year 1998	Fiscal year 1999
Revenues, as reported	$679	$1,186	$1,686
Revenues, as restated	642	1,173	1,624
Net income (loss), as reported	(183)	.205	89
Net income (loss), as restated	(302)	(103)	(223)

Source: SEC filings.

Accounting/Audit Firm

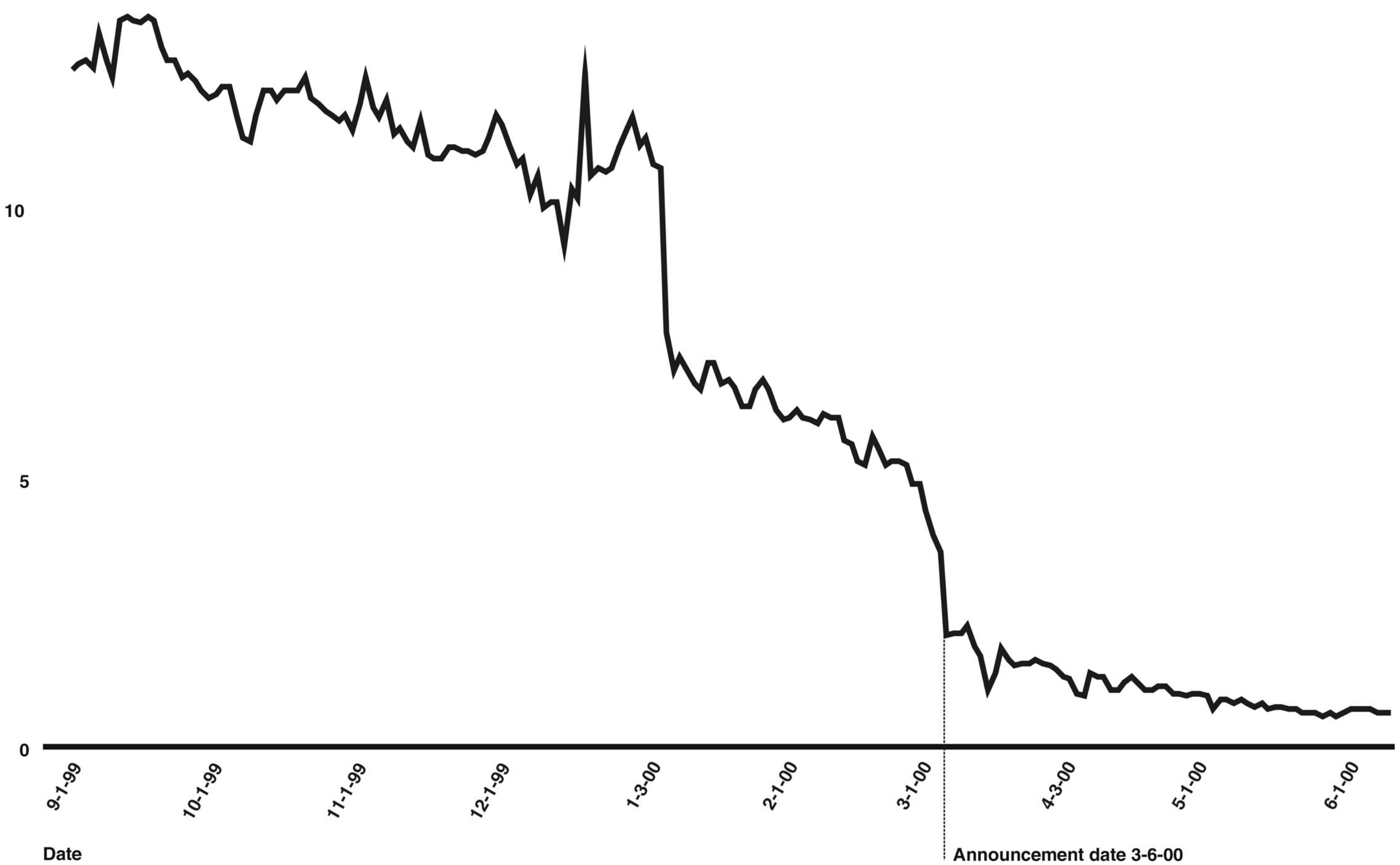
PricewaterhouseCoopers LLP (PwC) was the independent auditor during the periods in question. On March 8, 2000, PwC notified the company by letter that it was withdrawing its previously issued reports on the financial statements of the company for the fiscal years ending August 31, 1997, 1998, and 1999. PwC further stated that such reports should no longer be relied upon or associated with the company's financial statements for such years. On August 1, 2000, Safety-Kleen dismissed PwC and engaged Arthur Andersen LLP as its new independent accountant.

Stock Price

The company's common stock traded on the New York Stock Exchange (NYSE) under the ticker symbol SK until it was suspended from trading in June 2000 and was ultimately delisted on July 28, 2000. As of June 15, 2000, the company now trades over the counter under the ticker symbol SKLNQ. The company's stock price generally declined from December 1999 through February 2000 (fig. 21). Specifically, the stock price increased over 20 percent on December 17, 1999, following an analyst's recommendation earlier in the week. But this was quickly reversed as Safety-Kleen reported earnings that were below market expectations on January 5, 2000, and the stock price fell almost 30 percent. The trend remained negative through February 2000. Then on March 6, 2000, the date of the announcement of the preliminary internal investigation, Safety-Kleen's stock price fell 45 percent from the previous day's close of $3.63, to close at $2.00. On March 13, 2000, the company announced that it had been advised by SEC staff that a formal investigation of the company had been initiated. The next day, the

company's stock price fell once again to $1.06 per share, from its previous trading day's closing price of $2.06 per share. The trend generally remained negative, with the stock remaining under $1 per share until it was suspended from NYSE at $0.625 after the close on June 9, 2000.

Figure 21: Daily Stock Prices for Safety-Kleen, September 1, 1999-June 9, 2000



Source: GAO's analysis of NYSE Trade and Quote data.

Securities Analysts' Recommendations

Based on historical analyst recommendations that we were able to identify, prior to the March 6, 2000, restatement announcement, four firms rated Safety-Kleen. One recommended it as a moderate buy and the other three recommended a hold. After the restatement, the same firms changed the company's recommendation from moderate buy to hold. Also, one firm lowered its recommendation on Safety-Kleen from market outperform to market perform.

Credit Rating Agency Actions

Moody's Investors Service, Inc. (Moody's) and Standard and Poor's rated Safety-Kleen's debt. On May 7, 1999, before the restatement, Moody's assigned rating for Safety-Kleen indicated that its debt generally lacked desirable characteristics and assurance of interest and principal payments or maintenance of other terms of the contract over any long period of time. However, the company's outlook was considered stable. On September 13, 1999, before the restatement, Standard and Poor's assigned Safety-Kleen a slightly higher rating but rated the company's outlook as negative. On the announcement date of March 13, 2000, Standard and Poor's downgraded the company's rating, which indicated that it considered Safety-Kleen's obligations to be more vulnerable to nonpayment than previously. On March 10, 2000, Moody's changed its previous rating on Safety-Kleen's outlook from stable to negative and lowered Safety-Kleen's credit ratings for most of its debt. Subsequently, Standard and Poor's downgraded Safety-Kleen's debt rating on April 18, 2000, May 16, 2000, and ultimately removed the company from its rating list on July 26, 2000, and classified it as "not rated."

Legal and Regulatory Actions Taken

On June 9, 2000, Safety-Kleen and 73 of its domestic subsidiaries voluntarily filed for protection under Chapter 11 of the U.S. Bankruptcy Code.[117]

In the Spring of 2000, Safety-Kleen and certain officers and directors were named in various class actions brought by holders of its securities. The lawsuits charge, among other things, that the defendants made or caused

[117]Pursuant to the automatic stay provisions of Section 362 of the Federal Bankruptcy Code, 11 U.S.C. § 362, actions to collect prepetition indebtedness and virtually all litigation against the debtor that was or could have been brought prior to commencement of a Chapter 11 bankruptcy proceeding are stayed unless the stay is lifted by the court.

materially false and misleading financial statements regarding the company's financial condition. Cases brought by shareholders were consolidated. Certain bond holders subsequently filed a class action against the company and PwC on the same grounds.

In March 2000, shortly after the company's announcement of an internal investigation of its previously reported results and certain of its accounting policies and practices, Safety-Kleen announced that SEC had initiated a formal investigation into the company. The U.S. Attorney for the Southern District of New York also initiated an investigation into Safety-Kleen for accounting irregularities. According to Safety-Kleen, as of March 28, 2002, the company has responded to subpoenas issued by SEC and the grand jury in New York and is cooperating with both ongoing investigations.

SeaView Video Technology, Inc.

Business Overview

SeaView Videdo Technology, Inc., (SeaView) manufactures and sells underwater video cameras, lighting, and accessories for the marine, consumer retail, and commercial markets. It is also engages in the development, marketing, and sale of proprietary video security network devices and consumer electronic products that utilize patented technologies, licensed by the company, to retailers, commercial businesses and original equipment manufacturers throughout the United States. The company was originally incorporated as Gopher, Inc., in Utah on April 16, 1986. In order to change its domicile, Gopher, Inc., was reorganized under the laws of Nevada on December 30, 1993. On March 24, 1999, the company entered into a reorganization agreement with SeaView Underwater Research, Inc., a privately held Florida corporation. On February 2, 2000, the company changed its name to SeaView Video Technology, Inc. As of December 31, 2001, SeaView had net revenues of $732,401 and employed about 20 people.

Restatement Data

SeaView made two restatement announcements. The first restatement announcement was made on March 19, 2001, during an internal review of fiscal year 2000 operations that was undertaken by its newly hired chief financial officer (CFO). SeaView's original Form 10-Q for the quarters ended June 30 and September 30, 2000, incorrectly included as revenues and accounts receivable approximately $1.2 million and $2.3 million, respectively, of purchase orders that were received for new security camera products but were not shipped to the customers in time. After the restatement, the second and third quarter net revenues were approximately $335,120 and $212,592, respectively (table 19). The restatement also included a reduction in liabilities, totaling approximately $849,235, which were previously recorded relating to the purchase orders that were erroneously included as revenues. This restatement resulted in a reduction of net income by approximately $966,957 for the quarter ended June 30, 2000, and by approximately $871,639 for the quarter ended September 30, 2000. Net income was overstated by 468 percent during the 6-month period. The financials were restated on April 16, 2001.

Second, on April 16, 2002, SeaView again announced and restated its financial statements, this time for the full year 2000, to provide valuation allowances of over $1.4 million against deferred tax assets principally related to net tax operating loss carry forwards. Net income was overstated by about 65 percent during the 1-year period (table 19). The 2000 financial statements were also restated to reduce the original valuation of an equity

investment from almost $1.03 million to $146,200. The original valuation was based upon a discounted value of the company's common stock that the former chief executive officer (CEO), Richard L. McBride, personally committed in exchange for the equity investment.

Table 19: Selected Financial Data, 2000

(Dollars in thousands)

Affected financial data	Second quarter fiscal year 2000	Third quarter fiscal year 2000	Fiscal year 2000
Net revenues, as reported	$1,519	$2,465	$1,131
Net revenues as restated	335	213	N/A
Net income (loss), as reported	177	216	(2,204)
Net income (loss), as restated	(790)	(656)	(3,644)
Total assets, as reported	3,154	5,938	3,842
Total assets, as restated	2,473	3,808	1,521
Total liabilities, as reported	--	1,232	N/A
Total liabilities as restated	N/A	383	N/A

Note: N/A represents not applicable.

Source: SEC filings.

Accounting/Audit Firm

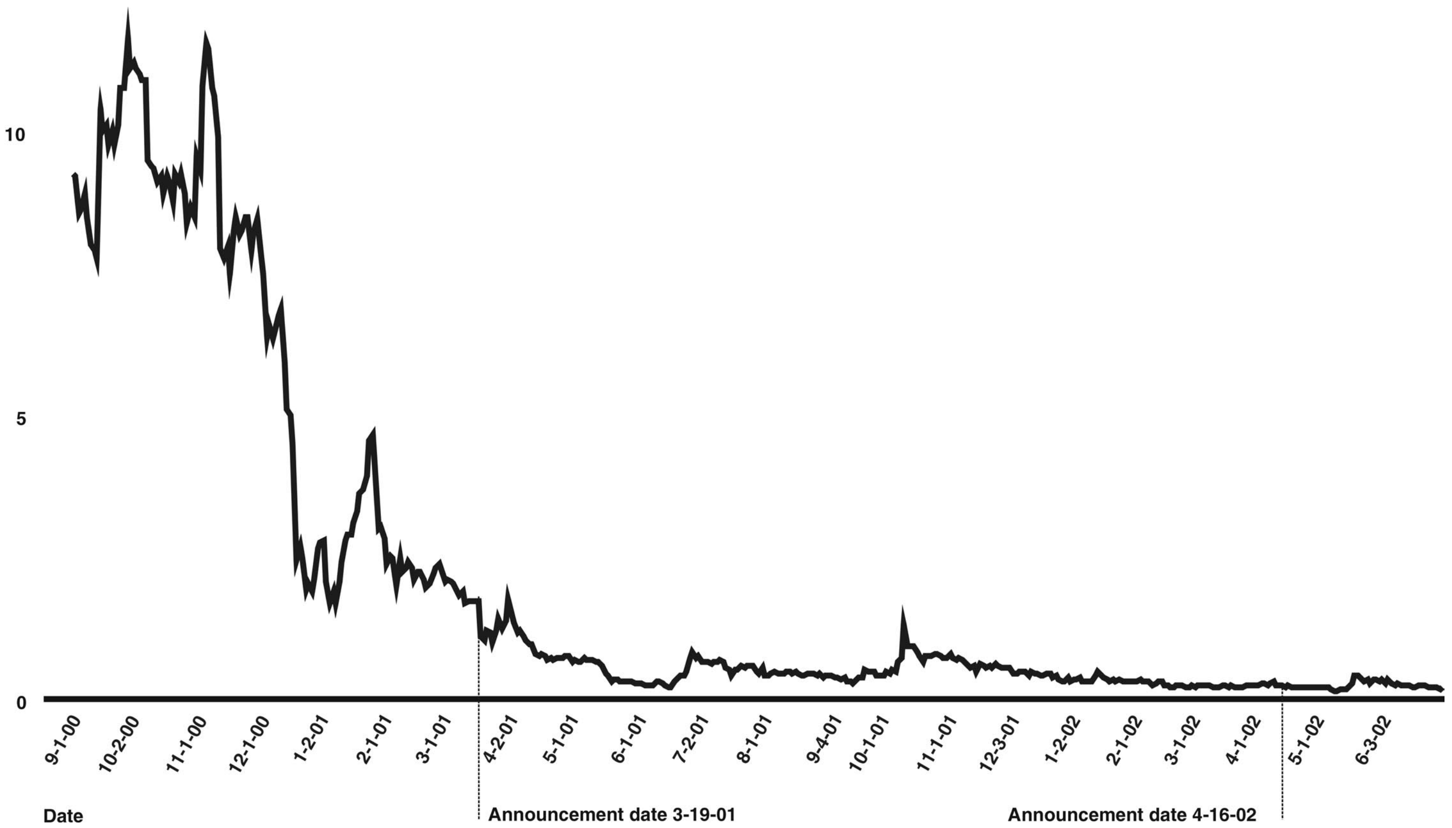
Carol McAtee, CPA (Carol McAtee) was the independent accountant during the relevant period and had served as the company's principal accountant since January 2000. On March 21, 2002, with the approval of the board of directors, SeaView dismissed Carol McAtee and engaged Aidman, Piser & Company P.A. as its independent accountant to audit the financial statements. On April 30, 2001, Carol McAtee sent a letter to the audit committee and management of SeaView stating that certain deficiencies existed with the internal control design of the company, which in the opinion of Carol McAtee could affect the company's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements. As a result of these

internal control deficiencies, several unspecified audit adjustments were proposed and recorded to SeaView's financial statements for the fiscal year ended December 31, 2000.

Stock Price

SeaView's common stock trades over-the-counter under the ticker symbol SEVU. The stock traded at over $11 per share in early November 2000, but it fell sharply to around $2 by January 2001. According to press reports, the announcement of complications in its negotiations to sell $80 million worth of equipment preceded the decline; and in a letter to shareholders, SeaView's CEO blamed the sharp drop on short sellers. SeaView's stock price recovered slightly. On February 20, 2001, the CEO stepped aside. On March 19, 2001, the stock price fell nearly 33 percent after SeaView announced that it would have to restate the second and third quarter financial results from the year 2000 (fig. 22). The stock price fell for much of 2001, generally trading below $0.50 per share by December 2001. The stock price suddenly peaked at $1.30 on October 11, 2001, several days after the death of the former CEO. The stock price then continued to fall and by SeaView's April 16, 2002, announcement that it would once again restate its financial statements, the stock price closed at $0.22 per share. From the time of SeaView's restatement announcement on March 19, 2001, to the issuance of its second restatement on April 16, 2002, SeaView's stock price fell over 80 percent from almost $1.12 to $0.22. As of June 28, 2002, the stock closed at $0.20.

Figure 22: Daily Stock Prices for SeaView, September 1, 2000–June 28, 2002



Source: GAO's analysis of Nasdaq data.

Securities Analysts' Recommendations

No information found.

Credit Rating Agency Actions

No information found.

Legal and Regulatory Actions Taken

SeaView was subject to shareholder and regulatory action related to its accounting practices. SeaView was a defendant in a consolidated class-action lawsuit in the U. S. District Court for the Middle District of Florida against the company and Mr. McBride, SeaView's former CEO.

Beginning in May 2001, plaintiffs filed five almost identical class-action lawsuits against SeaView and the company's president and CEO, Mr. McBride alleging that, among other things, from March 30, 2000, to March 19, 2001, SeaView and Mr. McBride misstated the company's sales and revenue figures; improperly recognized revenues; misrepresented the nature and extent of the company's dealer network; falsely touted purported sales contracts and agreements with large retailers; misrepresented the company's ability to manufacture, or to have manufactured, its products; and misrepresented SeaView's likelihood of achieving certain publicly announced sales targets. On July 24, 2001, those lawsuits were consolidated and the consolidated amended class-action complaint was filed in December 2001.

On July 1, 2002, SeaView and the lead counsel for the plaintiffs executed a memorandum of understanding, setting forth the basic terms of a settlement in the consolidated class-action lawsuit. The principal terms of the settlement require SeaView to tender to the plaintiffs, after the effective date of the settlement, 6,000,000 shares of SeaView common stock, which can be freely traded for the benefit of the class. SeaView will also pay up to $125,000 for costs incurred by the plaintiffs in this litigation, plus costs of settlement notice and administration.

According to SeaView's 2001 annual report, SEC initiated an investigation into unspecified matters related to SeaView's financial results and common stock performance during 2000. To date, SEC has not initiated action against SeaView or its officials.

Shurgard Storage Centers, Inc.

Business Overview

As of December 31, 2001, Shurgard Storage Centers, Inc. (Shurgard) is one of the largest owners and operators in the self-storage industry, with 479 properties under management in 21 states as well as Belgium, Denmark, France, the Netherlands, United Kingdom, and Sweden. With more than 1,000 employees, it is organized as a fully integrated real estate investment trust, which means the company develops, acquires, owns, leases, and manages its own storage centers. As of December 31, 2001, the company had revenues of $232.6 million and real estate operations accounted for about 97 percent of total revenues.

Restatement Data

On November 8, 2001, Shurgard announced the postponement of its previously announced third-quarter earnings. Its independent auditor, Deloitte & Touche LLP (Deloitte), informed the audit committee of the board of directors of its change in advice regarding the accounting treatment of four joint ventures the company had entered into since 1998. According to Deloitte, the proposed change in accounting treatment would require restatement of the company's financial statements for 1998, 1999, 2000, and the first 6 months of 2001. According to Shurgard officials, after notification of the auditor's change in opinion regarding the accounting treatment for the development joint ventures, the company submitted the proposed new accounting treatment to the Office of the Chief Accountant (OCA) of the Securities Exchange Commission (SEC).[118] Prior to the company filing restated financial statements, OCA advised the company that it did not object to the proposed new accounting treatment for the joint ventures. The company believed that the restatement would result in a material adverse impact on previously reported income. On December 4, 2001, Shurgard announced that it had amended its annual report for fiscal year ended December 31, 2000 (table 20).

[118]This submission was made pursuant to a procedure that allows for the prior review by OCA of accounting for transaction considered to be complex or highly technical in nature.

Table 20: Selected Financial Data, 1998–2001

(Dollars in millions)

Affected financial	Fiscal year 1998	Fiscal year 1999	Fiscal year 2000	First quarter 2001	Second quarter 2001
Net income, as reported	$44.7	$50.7	$52.6	$10.7	$15.7
Net income, as restated	35.2	36.6	32.3	4.1	10.0

Source: SEC filings.

Shurgard agreed with its independent auditor that the four joint venture arrangements entered into from 1998 to 2000 should have been accounted for as financing arrangements from inception. However, these arrangements were previously included in Shurgard's consolidated statements and the ventures partners' share of the operating results were reflected as minority interest in the consolidated statements. The excess of the repurchase price of the joint venture properties over the original sales prices to the joint venture was capitalized in a manner similar to the acquisition of minority interests. It was also determined that the company had not appropriately changed its method of accounting for the participation features included in a mortgage loan assumed.

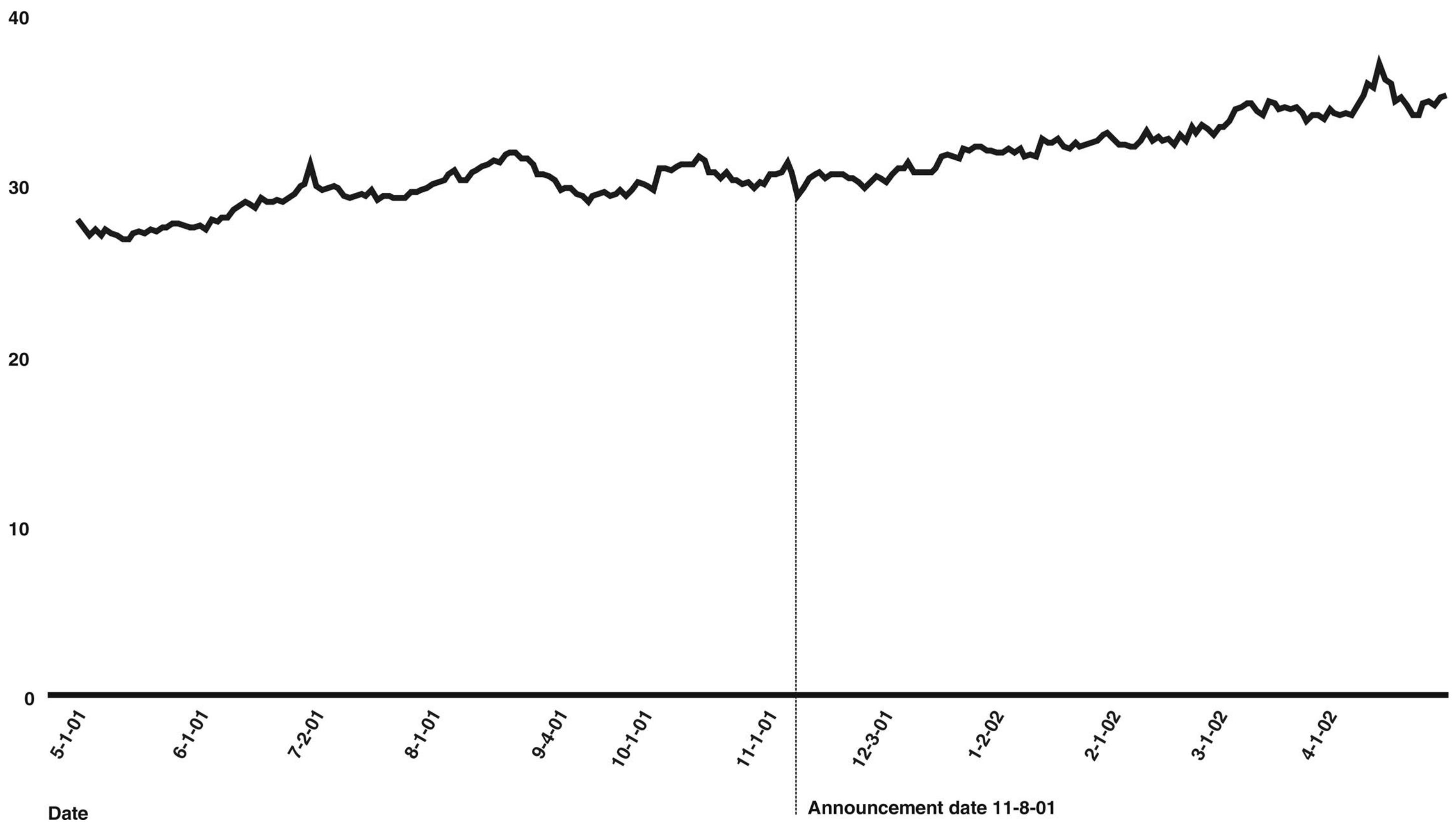
Accounting/Audit Firm

Deloitte was the company's independent auditor during the relevant period.

Stock Price

Shurgard's stock is traded on the New York Stock Exchange (NYSE) under the ticker symbol SHU. The stock price trended slightly higher from May 2001 until November 2001 (fig. 23). On November 7, 2001, the date before the restatement announcement, the stock price closed at $30.76. On the day of the restatement announcement, the stock price closed at $29.38, a loss of around 4.5 percent. The following day, the stock price closed at $29.78. The announcement of the restatement appeared to have little longer-term impact on the stock price, as it continued its upward trend through April 2002 and closed in the mid-thirties.

Figure 23: Daily Stock Prices for Shurgard, May 1, 2001–April 30, 2002



Source: GAO's analysis of NYSE Trade and Quote data.

Securities Analysts' Recommendations

Based on available historical securities analysts rating information we identified, we found that five analysts that covered Shurgard from 2000 through 2001. A few months prior to the November 8, 2001, restatement announcement, one analyst upgraded the company's rating from neutral to outperform. One analyst downgraded Shurgard's rating (from hold to sell) on November 8, 2001, following its restatement announcement.

Credit Rating Agency Actions

The company's securities are rated by Moody's Investors Service, Inc. (Moody's) and Standard and Poor's. On April 29, 1997, Standard and Poor's rating of Shurgard's senior unsecured debt and preferred stock indicated that the obligations generally have adequate protection measures, but that adverse economic conditions or changing circumstances are more likely to lead to a weakened capacity of the company to fulfill its financial commitment on the debt. On February 14, 2001, Shurgard's debt received a medium-grade debt rating from Moody's, which indicated that the bonds are neither highly protected nor poorly secured and are ranked mid-range. In addition, principal and interest payments appear adequate for the present, but the long-term certain protective elements may be lacking. This rating remained unchanged throughout 2001. As of August 2002, Standard and Poor's had not changed its rating since 1997.

Legal and Regulatory Actions Taken

To date, there has been no civil or regulatory action taken with regard to Shurgard's restatement announcement.

Sunbeam Corporation

Business Overview

Sunbeam Corporation (Sunbeam) designs, manufactures, markets and supplies branded consumer products. The company's product categories include appliances, health care, personal care and comfort, and camping products. Appliances include mixers, blenders, food steamers, toasters, irons and garment steamers. The significant trademarks of the company are Sunbeam, Coleman, Oster, Mr. Coffee, Health O Meter, First Alert, Campingaz, and Powermate. Outdoor leisure accounted for 40 percent of 1999 revenues; household appliances, 35 percent; and international sales, 25 percent. On February 6, 2001, Sunbeam filed for bankruptcy protection under Chapter 11. On September 9, 2002, a reorganization plan was filed with the bankruptcy court and a hearing for the company to emerge from bankruptcy will be held on November 4, 2002.

Restatement Data

Around year-end 1996, Sunbeam created accounting reserves, which increased Sunbeam's reported loss for 1996. According to the Securities and Exchange Commission (SEC or Commission) complaint, filed May 15, 2001, these reserves were then allegedly used to inflate income in 1997, thus contributing to the false picture of a rapid turn around.

On June 30, 1998, Sunbeam announced that the audit committee of the board of directors would conduct a review of Sunbeam's prior financial statements. Sunbeam also announced that Deloitte & Touche LLP had been retained to assist the audit committee and Arthur Andersen LLP (Arthur Andersen) in its review of Sunbeam's prior financial statements. On August 6, 1998, Sunbeam announced that the audit committee had determined that Sunbeam would be required to restate its financial statements for 1997, the first quarter of 1998 and possibly 1996, and that the adjustments, while not then quantified, would be material. Sunbeam announced on October 20, 1998, the restatement of its financial results for a 6-quarter period from the fourth quarter of 1996 through the first quarter of 1998. The restatement reduced the 1996 net loss by $20 million (9 percent of reported losses); it reduced 1997 net income by $71 million (65 percent of reported earnings); and it increased 1998 earnings by $10 million (21 percent of reported losses). See table 21.

Table 21: Selected Financial Data, 1996 – 1998

Dollars in millions

Affected financial data	Fiscal year 1996	Fiscal year 1997	First quarter fisca1 year 1998
Net income (loss), as reported	$(228.3)	$109.4	$(44.6)
Net income (loss), as restated	(208.5)	38.3	(54.1)

Source: SEC filings.

The incorrectly reported numbers affected numerous accounts. Sunbeam concluded, based upon its review, that for certain periods revenue was incorrectly recognized (principally “bill and hold” and guaranteed sales transactions), certain costs and allowances were not accrued or were incorrectly recorded (principally allowances for sales returns, co-op advertising, customer deductions and reserves for product liability and warranty expense), and certain costs were incorrectly included in and charged to restructuring, asset impairment and other costs.

Accounting/Audit Firm

Arthur Andersen was the independent auditor and wrote unqualified opinions for Sunbeam, although Arthur Andersen’s engagement partner, Phillip Harlow, was allegedly aware of Sunbeam’s accounting improprieties and disclosure failures. On May 15, 2001, Mr. Harlow was charged with fraud along with Sunbeam’s former senior management team, led by Mr. Albert J. Dunlap, chairman of the board. The suit is still pending. Details are provided in the “Legal and Regulatory Actions Taken” section of this case.

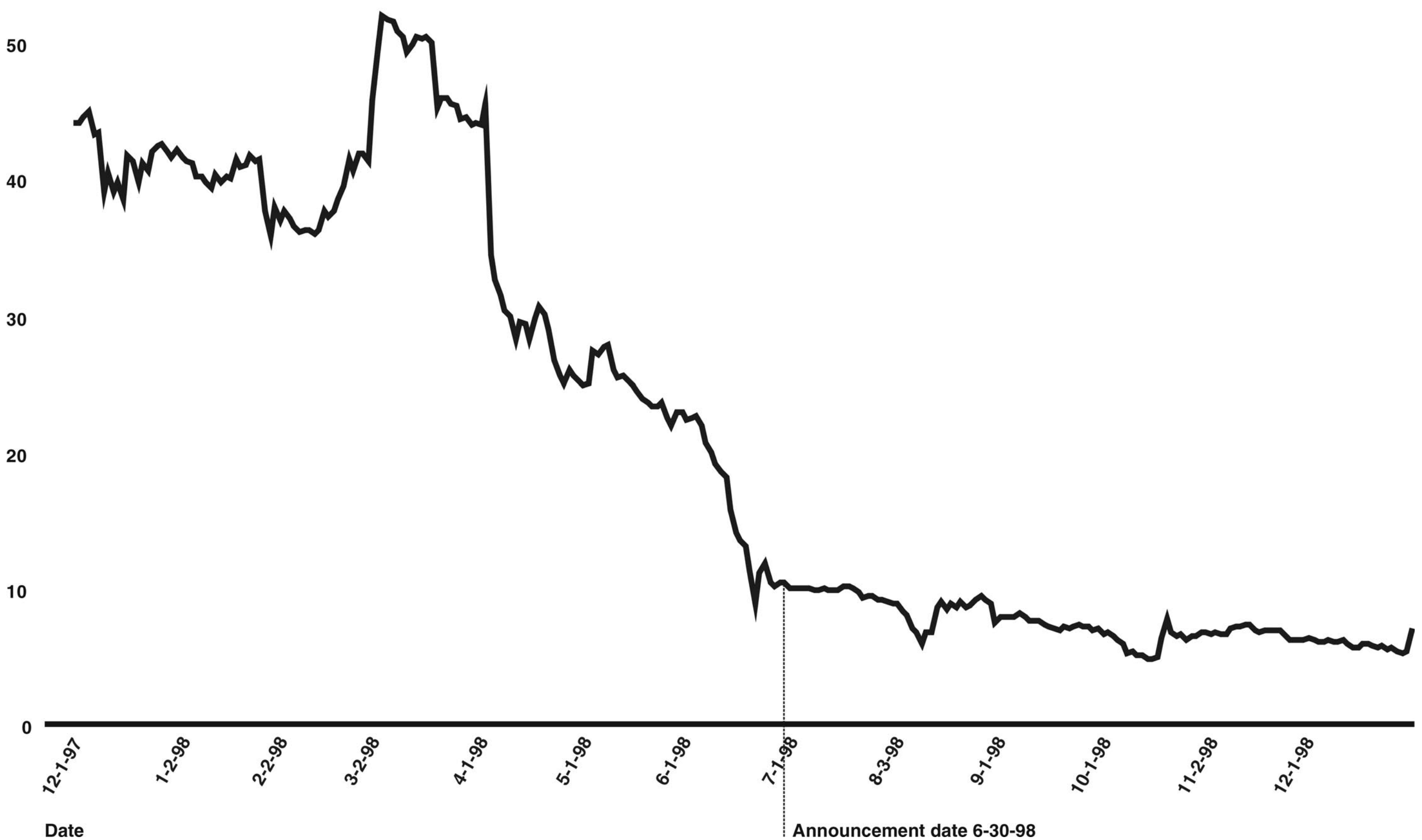
Stock Price

Sunbeam stock was traded on the New York Stock Exchange (NYSE) under the ticker symbol SOC. However, on February 6, 2001, NYSE suspended trading of Sunbeam stock and subsequently delisted the company in 2001. It currently trades over the counter as SOCNQ. On March 4, 1998, Sunbeam stock hit a high of $52 per share (fig. 24). The stock price fell over 9 percent on March 19 after Sunbeam issued a profit warning; then on April 3, 1998, the stock price fell another 25 percent to $34 after Sunbeam issued a second profit warning. The stock continued to fall through April and May 1998. Following a June 8, 1998, article in *Barron’s* suggesting that Sunbeam engaged in “accounting gimmickry,” the reports of an SEC inquiry, and the firing of Mr. Dunlap, the stock declined from over $20 per share to under

$10 per share by July 1998. By the date of the financial restatement announcement on June 30, 1998, the stock price closed at $10.375. The stock price continued its generally downward trend in late 1998.

Figure 24: Daily Stock Prices for Sunbeam, December 1, 1997–December 31, 1998

60 Price per share in dollars



Source: GAO's analysis of NYSE Trade and Quote data.

Securities Analysts' Recommendations

Based on historical analysts' recommendations we were able to identifiy, in mid-1997, in the middle of Sunbeam's stock price appreciation, analysts were touting Sunbeam as a future leader in the industry. One analyst's

earnings estimate was $1.55 per share in 1997 and $2.25 per share in 1998. Analysts speculated that Sunbeam's earnings could reach $3 per share in 1999. The actual earnings based on SEC filings were $0.62 per share, a loss of $7.99 per share, and a loss of $2.97 for 1997, 1998, and 1999, respectively.

Based on news in April 1998 that sales would be down for the first quarter of 1998, one firm downgraded the company's stock. After the restatement warning in June 1998, another firm downgraded its rating to a sell.

Credit Rating Agency Actions

Moody's Investors Service, Inc. (Moody's) and Standard and Poor's rated Sunbeam's debt. On June 16, 1998, two weeks prior to Sunbeam's restatement announcement on June 30, 1998, Moody's assigned a poor rating to Sunbeam's zero coupon convertible senior subordinated notes. They did not take action after the restatement announcement. Standard and Poor's withdrew Sunbeam's issuer credit rating on August 15, 1992. Therefore, it did not rate Sunbeam at the time the company restated its financial statements or declared bankruptcy on February 6, 2001

Legal and Regulatory Actions Taken

On February 6, 2001, Sunbeam filed for Chapter 11 bankruptcy protection under U.S. Bankruptcy Court.[119]

In January 1999, a consolidated class-action lawsuit against Sunbeam, its auditor, Arthur Andersen, and Sunbeam principals was filed in the U.S. District Court for the Southern District of Florida. The complaint alleged that, among other things, from March 19, 1998, through April 3, 1998, Sunbeam and the chief executive officer (CEO) of the company, Albert Dunlap, violated the federal securities laws (Sections 10(b) and 20(a) of the Securities Exchange Act of 1934 (Exchange Act) and Rule 10b-5) by, among other things, misrepresenting and/or omitting material information concerning the business operations, sales and future prospects of the company. The suit reached final settlement on August 9, 2002. Sunbeam was not a party in the final settlement due to its previous bankruptcy filing. The total settlement amount was $141 million. The largest portion came from Sunbeam's accountant at the time, Arthur Andersen, which agreed to

[119]Pursuant to the automatic stay provisions of Section 362 of the Federal Bankruptcy Code, 11 U.S.C. § 362, actions to collect prepetition indebtedness and virtually all litigation against the debtor that was or could have been brought prior to commencement of a Chapter 11 bankruptcy proceeding are stayed unless the stay is lifted by the court.

pay $110 million in April 2001. Since that time the money has been held in escrow earning interest, pending the final settlement with Sunbeam. Mr. Dunlap, the former CEO, also paid $15 million. Another portion of the settlement came from the Chubb Group's Executive Risk Indemnity Inc. ($13.5 million), and Great American Insurance Group ($2 million). Both firms had policies covering Sunbeam officials.

On May 15, 2001, SEC filed a civil action in the U.S. District Court of Miami against five former officers of Sunbeam (Mr. Dunlap, chairman and CEO; Russell Kersh, chief financial officer (CFO); Robert Gluck, chief accounting officer; Donald R. Uzzi and Lee B. Griffith, former vice presidents) and Phillip Harlow, former Arthur Andersen engagement partner. On May 15, 2001, SEC also instituted an administrative proceeding against Sunbeam, which was concurrently settled. The complaint charged Sunbeam with filing false and misleading reports with the Commission from the fourth quarter of 1996 through the first quarter of 1998. Sunbeam consented to the entry of a cease-and-desist order prohibiting future violations of the antifraud, reporting, books and records, and internal controls provisions of the securities laws. Finally, an administrative action was also filed and concurrently settled against David Fannin, former Sunbeam general counsel, for participating in drafting misleading press releases on the company's operations.

The civil complaint alleges that Messrs. Dunlap and Kersh, together with others, employed improper accounting techniques and undisclosed nonrecurring transactions to misrepresent Sunbeam's results of operations. According to SEC's complaint, through this conduct, Messrs. Dunlap and Kersh, personally and as controlling persons within the meaning of Section 20(a) of the Exchange Act, and Messrs. Gluck and Griffith violated or aided and abetted violations of Section 17(a) of the Securities Act of 1933 and Sections 10(b), 13(a), 13(b)(2)(A), 13(b)(2)(B) and (with the exception of Mr. Dunlap) 13(b)(5) of the Exchange Act and Rules 10b-5, 12b-20, 13a-1, 13a-13, 13b2-1, and 13b2-2 thereunder; and Messrs. Uzzi and Harlow violated or aided and abetted violations of all of the above provisions, except Exchange Act Rule 13b2-2. SEC seeks, permanent injunctions against all defendants for future violations of the above provisions of the securities laws and civil penalties and, in the case of Messrs. Dunlap, Kersh, Gluck, and Uzzi, seeks permanent bars from acting as an officer or director of any public company.

On September 4, 2002, Messrs. Dunlap and Kersh agreed to settle their cases with SEC, while not admitting or denying guilt. Mr. Dunlap paid

$500,000 in the settlement and Mr. Kersh paid $200,000. Both agreed to be barred permanently from serving as an officer of a public company. The civil suit is still pending against the other officers, and a trial is set for mid-January 2003.

Thomas & Betts Corporation

Business Overview

Thomas & Betts Corporation (Thomas & Betts) is a designer, manufacturer, and marketer of electrical components and systems for connecting, fastening, protecting, and identifying wires, components, and conduits. As of December 31, 2000, the company had reported net sales of $1.76 billion and it employed approximately 14,000 people.

Restatement Data

Thomas & Betts announced planned restatements to its financial statements in 1999 and again in 2000. First, on October 26, 1999, Thomas & Betts announced that it might restate the first and second fiscal quarters 1999 and prior fiscal years. Upon review with its independent auditors, KPMG LLP, and after review and consultation with the audit committee of its board of directors, Thomas & Betts decided to restate its previously issued financial statements for quarters ended April 4, 1999, and October 3, 1999. In November 1999, Thomas & Betts filed its Form 10-Q with the Securities and Exchange Commission (SEC or Commission). On December 20, 1999, Thomas & Betts announced that it has completed its previously reported review of certain accounting matters, which has largely resulted from or had been identified by conversions of its worldwide financial systems. As a result of that review, the company concluded, with the concurrence of KPMG LLP that attribution of adjustments to the first and third quarters of 1999 as previously announced should be modified. That modification resulted in a $2.2 million increase in first-quarter net earnings and a $3.1 million decrease in third-quarter net earnings from amounts disclosed in the company's Form 10-Q filed November 17, 1999. Consequently, a revised Form 10-Q (amended) was filed for the first and third quarters reflected net income for the first quarter of 1999 of $34.5 million and net income for the third quarter of 1999 of $46.9 million.

To address poor performance, Thomas & Betts initiated several key management changes. It hired a new chief financial officer (CFO) and elected a new chairman and chief executive officer (CEO). During 2000, the new management team began a comprehensive review of processes, controls and systems. As a result of these reviews, management identified, primarily in the second quarter of 2000, certain prior-period adjustments, which necessitated a restatement of its financial statements for the first and second quarters of 2000 and previous quarters. On August 21, 2000, Thomas & Betts announced that it had recorded certain special charges as of July 2, 2000. It also announced that while the charges were based on the best available information, management was continuing to review with its independent auditors the amounts and attribution of the special charges to

the appropriate reporting periods. Although the review was ongoing, Thomas & Betts announced that it planned to restate its financial statements for 1999. Since a portion of these special charges recorded in the second quarter 2000 were attributable to fiscal 1999, adjustments had to be made in fiscal 1999 and the second quarter of 2000. Upon completion of the review, on March 29, 2001, the company filed its Form 10-K for fiscal year 2000 with SEC, which contained restated financials for fiscal years 1996 through 1999, all four quarters of fiscal 1999, and the first two quarters of fiscal 2000 (see table 22).

Table 22: Selected Financial Data, 1996-2000

(Dollars in millions)

Affected financial data	Fiscal year 1996	Fiscal year 1997	Fiscal year 1998	Fiscal year 1999	First quarter fiscal year 2000	Second quarter fiscal year 2000
Net sales, as reported	$2,134.4	$2,259.5	$2,230.4	$2,522.0	$462.9	$285.5
Net sales, as restated	2,130.3	2,248.2	2,212.2	2,467.4	449.4	200.1
Net income (loss), as reported	73.5	162.3	87.5	148.3	35.9	(36.8)
Net income, as restated	68.1	148.3	81.2	119.3	23.3	21.4

Note: Restated net sales does not included reclassification adjustments made to implement Emerging Task Force Issue No. 00-10, “Accounting for Shipping and Handling Fees and Costs,” or adjustments for discontinued operations.

Source: SEC filings.

Accounting/Audit Firm

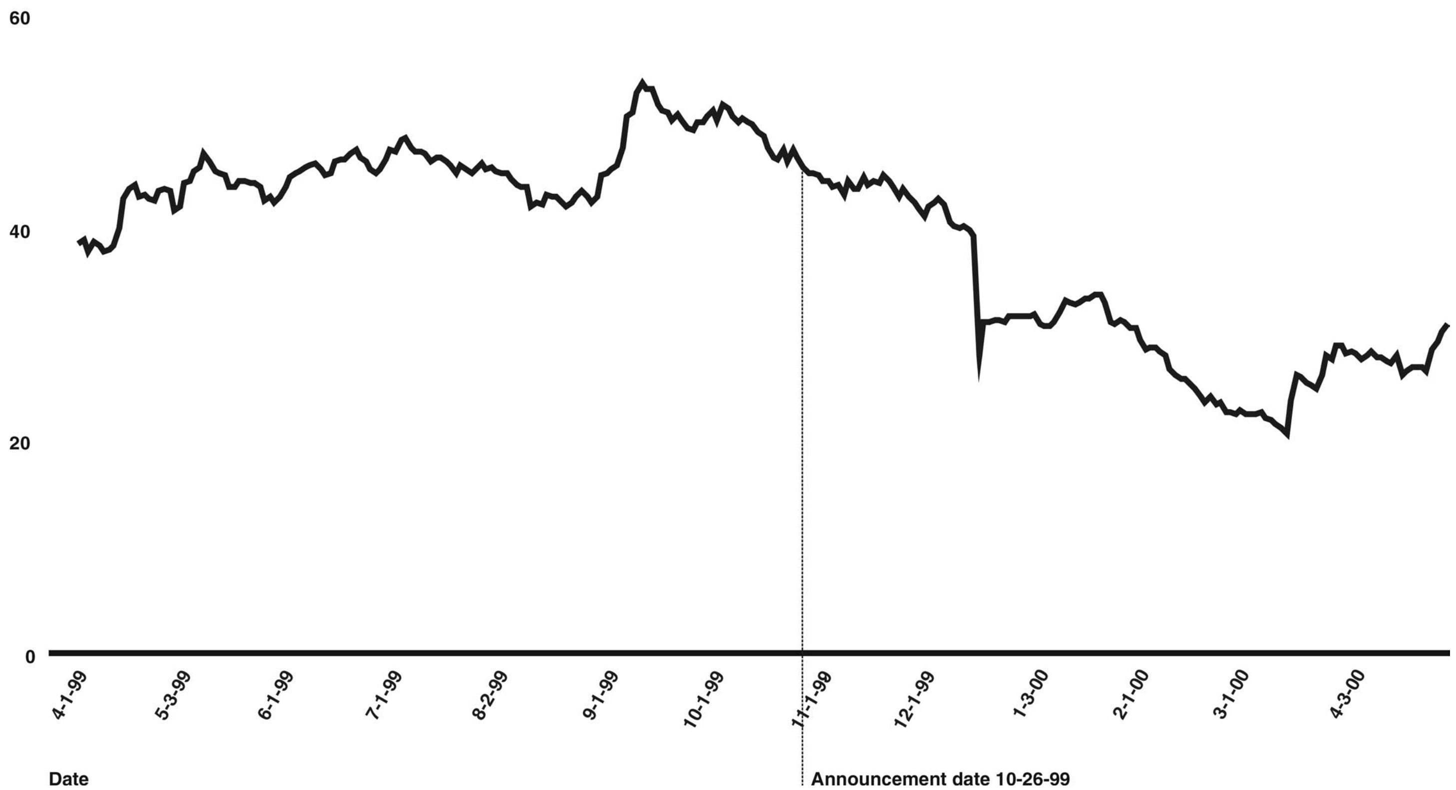
KPMG LLP was the independent auditor during the restatement period.

Stock Price

The company’s stock trades on the New York Stock Exchange (NYSE) under the ticker symbol TNB. The stock price of Thomas & Betts fluctuated around the mid-$40 range from April through August 1999 (fig. 25). The stock price peaked at over $53 in mid-September following the company’s decision to drop out of the bidding for a rival cable manufacturer. The stock price closed at $45.625 on October 26, 1999, down slightly from the

previous close of $46.50, after reporting third quarter earnings that were consistent with analysts' expectations and announcing the restatement. The stock price generally trended downward over the next month, ending November 1999 at $41.00. On December 15, 1999, a brokerage firm downgraded Thomas & Betts sending the stock price down almost 30 percent from $39.188 to $27.875.

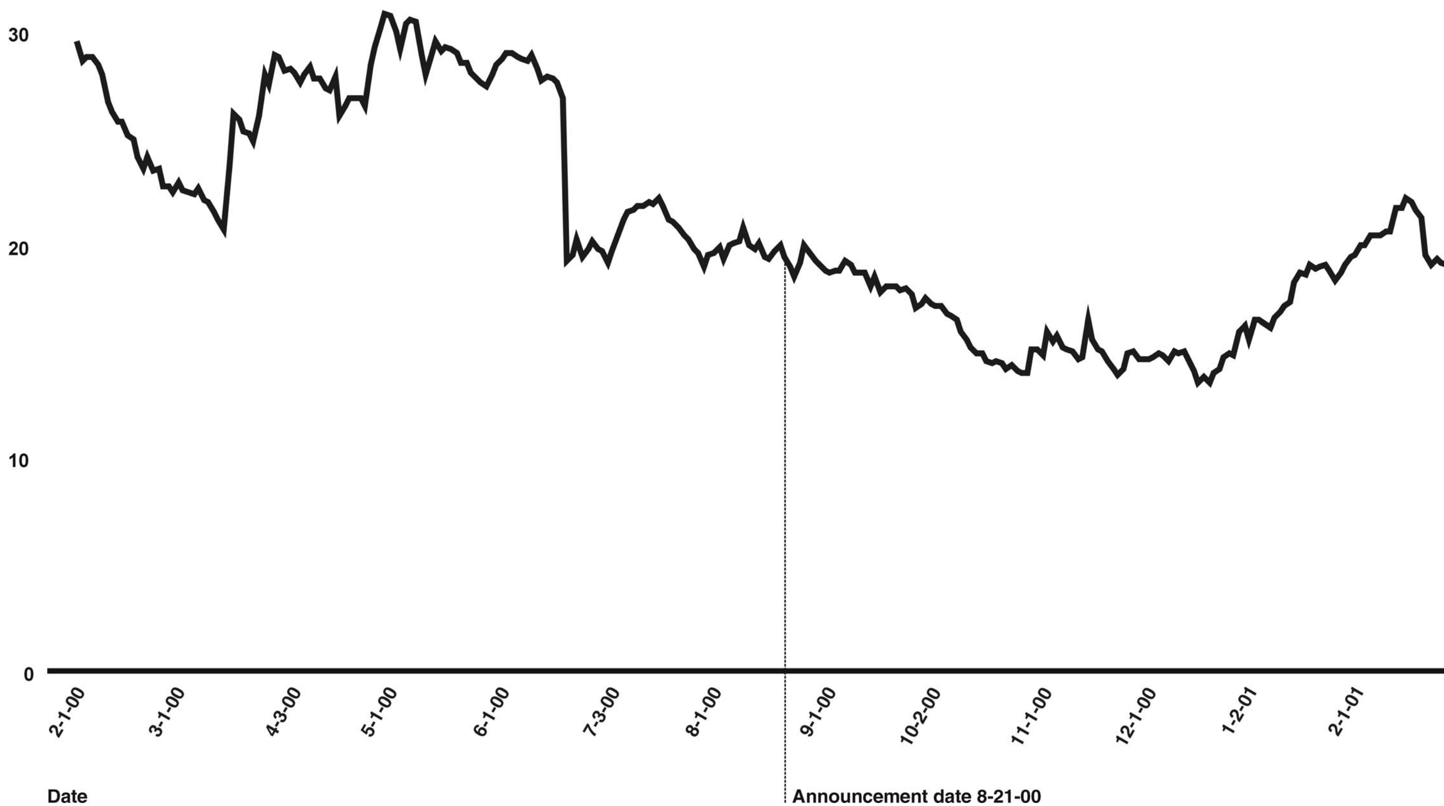
Figure 25: Daily Stock Prices for Thomas & Betts, April 1, 1999 – April 30, 2000



Source: GAO's analysis of NYSE Trade and Quote data.

On June 19, 2000, Thomas & Betts reported that it expected second quarter earnings to come in significantly below the current analyst consensus of $0.74 per share, excluding an anticipated gain on the sale of the company's electronic original equipment manufacturer business. The company stated that the expected earnings decrease would primarily result from a likely increase in provisions for sales and accounts receivable deductions. On June 19, 2000, the stock price closed at $26.81, and the following day closed at $19.18, a decline of more than 28 percent (fig. 26). On August 14, 2000, the company's stock price closed at $20.06. By the end of that week, it closed at $20.00, virtually unchanged. On Monday of the following week (August 21, 2000), Thomas & Betts announced its planned restatement, and its stock price closed at $19.38. The next day, it declined further to $18.94, a decline of about 5 percent over these 3 days.

Figure 26: Daily Stock Prices for Thomas & Betts, February 1, 2000–February 28, 2001



Source: GAO's analysis of NYSE Trade and Quote data.

Securities Analysts' Recommendations

Based on available historical information on securities analyst ratings, in the months preceding the August 2000 restatement announcement, one firm lowered its investment recommendation from a buy to market performance. In November 2000, and twice in 2001, one firm cut its earnings estimates for the company. Another firm in 2001 also cut Thomas & Betts's earnings estimate. And in July 2001, several months after the

restated financials were filed with SEC, one brokerage firm downgraded its recommendation to market perform.

Credit Rating Agency Actions

Thomas & Betts's debt is rated by Moody's Investors Service, Inc. (Moody's) and Standard and Poor's. In August 2000, Moody's debt rating for the company indicated that Thomas & Betts's obligations were neither highly protected nor poorly secured and lacked outstanding investment characteristics. From August 2000 and throughout 2001, Moody's rating for the corporate bond remained unchanged.

In December 2000, Standard and Poor's downgraded Thomas & Betts' corporate credit rating indicating that the company has adequate capacity to meet its financial commitments, but that adverse economic conditions or changing circumstances are more likely to lead to a weakened capacity of the company to meet its financial commitments.

Legal and Regulatory Actions Taken

Thomas & Betts was subject to shareholder lawsuits and regulatory action related to its accounting practices. During 2000 certain shareholders of the Corporation filed five separate class-action suits in the U.S. District Court for the Western District of Tennessee against Thomas & Betts, Clyde R. Moore, former CEO, and Fred R. Jones, former CFO. The complaints allege fraud and violations of Section 10(b) and 20(a) of the Securities Exchange Act of 1934 (Exchange Act) and SEC Rule 10b-5. The plaintiffs allege that purchasers of Thomas & Betts common stock between April 28, 1999, and August 21, 2000, were damaged when the market value of the stock dropped by nearly 29 percent on December 15, 1999; dropped nearly 26 percent on June 20, 2000; and fell another 8 percent on August 22, 2000. An unspecified amount of damages is sought.

On December 12, 2000, all five of the actions were consolidated into a single action. The consolidated complaint essentially repeats the allegations in the earlier complaints. On April 9, 2002, the U.S. District Court for the Western District of Tennessee entered an order granting in part and denying in part the company's Motion to Dismiss in the shareholder class-action lawsuit. The court dismissed allegations against Mr. Moore, former CEO, and Mr. Jones, former CFO, for violations of Section 10(b) and Rule 10b-5 under the Exchange Act. The court also granted KPMG LLP's Motion to Dismiss in a parallel shareholder class-action lawsuit.

On July 24, 2002, the court refrained from establishing a schedule for pretrial discovery in this case. The Court instead ordered that the parties enter into formal mediation proceedings immediately. A formal order controlling the mediation is expected in the near future.

Soon after issuing the August 21, 2000, press release announcing substantial charges ($223.9 million) in the second fiscal quarter of 2000, Thomas & Betts received an informal request for information regarding the basis of the charges from SEC. According to the company's fiscal year 2000 annual report, on January 4, 2001, SEC initiated a formal order of investigation concerning the company's financial reporting and other matters. To date, no additional action has been taken.

Waste Management, Inc.

Business Overview

Waste Management, Inc., was created in 1998 when USA Waste Services, Inc. of Houston acquired the Chicago based Waste Management, Inc., and then adopted the name Waste Management.[120] Waste Management provides integrated waste management services, consisting of collection, transfer, disposal, recycling, and resource recovery services. In addition, it provides hazardous waste services to commercial, industrial, municipal and residential customers. Waste Management serves about 27 million municipal, business, and residential customers in the United States, Canada, and Puerto Rico. It has a network of 600 landfills and transfer stations, 1,400 collection centers, as well as disposal and recycling services. To focus on its core North American operations, Waste Management has sold off its international solid- and hazardous-waste management businesses. For the fiscal year ended December 31, 2001, sales were $11.32 billion. Net income before extraordinary items and accounting changes totaled $503 million.

Restatement Data

In early September 1997, prior to being acquired by USA Waste Services, Waste Management, Inc., initiated a broad-ranging analysis of its North American operating assets and investments, and it stated that it might record a charge that could be material to its results for the year. On October 30, 1997, Ronald T. LeMay, chief executive officer (CEO), who had been hired in mid-1997, resigned. On November 4, 1997, Waste Management announced that it had established an executive search committee to identify a new CEO and also indicated that the previously announced review would reflect a more conservative management philosophy. Then, on November 14, 1997, the company announced that, as a result of the ongoing study of the company's business operations, it recorded a $173.3 million, or $0.24 per share, charge in the third quarter of 1997, cutting earnings per share to $0.14 from a previously reported $0.38. The charge reflected write-downs of assets, increased reserves for litigation and insurance and environmental costs. The charges also included reclassifying income and expense accounts between continuing and discontinuing operations. In addition, the company reclassified or adjusted certain items

[120]According to comments received from the company, Waste Management, Inc., is a relatively new company created in 1998 when USA Waste Services, Inc. of Houston (New Waste Management) acquired the Chicago based Waste Management Inc. (Old Waste WMX), and then adopted the name Waste Management. For purposes of this case, we use Waste Management to cover restatement announcements of both the Old Waste WMX and New Waste Management.

in its financial statements for 1996 and the first 9 months of 1997, although these reclassifications and adjustments had no impact on 1996 earnings and an insignificant impact on 1997 earnings, according to the company. On January 5, 1998, the company announced that, in response to a request from the Securities and Exchange Commission's (SEC or Commission) Division of Corporation Finance, it had agreed to file amended reports in Forms 10-K and 10-Q for the year ended December 31, 1996, and for the 3-month periods ended March 31, 1997, and June 30, 1997. The amended reports were to contain restated financial statements and revised management discussion and analysis reflecting information contained in its Form 10-Q for the 3 months ended September 30, 1997. The company also stated that the ongoing review would likely necessitate revisions to previous classifications of various items of income and expense reported in its 1994 and 1995 financial statements. Ultimately, the company announced a financial statement restatement on January 29, 1998, and filed an amended Form 10-K on February 24, 1998, with SEC. Earnings were restated for the period from 1992 to 1997, totaling $1.3 billion (table 23). The incorrectly reported numbers were primarily expense related. Depreciation expense was misstated due to incorrect vehicle, equipment, and container salvage value assumptions and capitalized interest relating to landfill construction projects was misstated.

On August 3, 1999, after the acquisition of Chicago-based Waste Management by USA Waste Services, the new company, Waste Management, which was under new senior management, announced that an internal audit might cause it to revise first quarter 1999 results. It singled out $95 million reported as operating income that instead should potentially have been calculated as nonrecurring items. On August 16, 1999, the company filed its Form 10-Q including the results of its review, determining that it had incorrectly reported $30.2 million as first quarter pretax income, which instead should have been reflected over the life of certain landfill assets. Including charges, earnings for the 3 months ended March 31 were revised to $346.7 million, compared with $364.3 million as previously reported (table 23).

Table 23: Selected Financial Data, 1992-1999

Dollars in millions

Affected financial data	1992[a]	1993[a]	1994[a]	1995[a]	1996[a]	1997[a]	First quarter 1999[b]
Net Income (loss), as reported	850	453	784	604	192	(995)	364
Net Income (loss), as restated	740	289	628	340	(39)	(1,176)	347

[a]Resulting from the initial restatement announcement on November 14, 1997.

[b]Resulting from the initial announcement on August 3, 1999. New Waste Management has not restated financials for any independently audited period.

Source: SEC filings.

Accounting/Audit Firm

Arthur Andersen LLP (Arthur Andersen) was the company's independent auditor and wrote unqualified opinions for the company during the periods that were eventually restated, although Arthur Andersen had identified the company's improper accounting practices and quantified those practices in relation to the company's financial statements. According to the complaint filed by SEC, these misstatements were presented annually to the company's management, along with "Proposed Adjusting Journal Entries" to correct the errors.

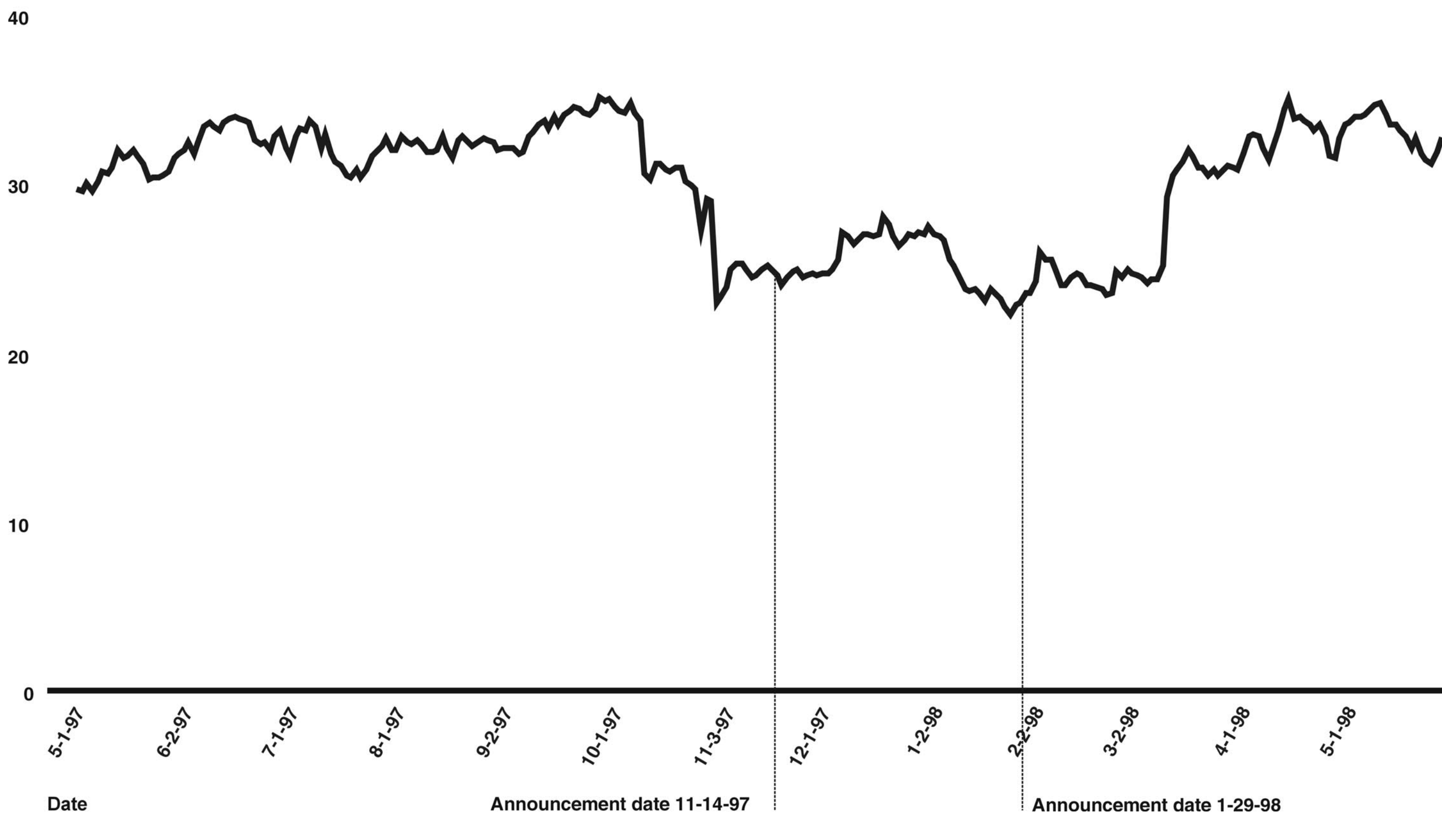
Stock Price

Waste Management trades on the New York Stock Exchange (NYSE) under the ticker symbol WMI.[121] Prior to the merger, there appeared to be little immediate impact from the initial restatement announcement by the company in November 1997 or the subsequent clarifications made in January and February 1998, with the stock price hovering around $25 per share (fig. 27). The stock price dropped 9 percent with the warning on October 10, 1997, that third-quarter earnings would fall below estimates; the announcement on October 30, 1997, of the sudden resignation of Mr. LeMay after less than 4 months as CEO had a much greater impact as the stock price declined 20 percent. The company's stock price rebounded in

[121]Old Waste Management was listed on NYSE prior to the merger in which USA Waste Services acquired Old Waste Management. Old Waste Management changed its name to Waste Management Holdings, Inc. on July 16, 1998, and is no longer a publicly traded company.

early March 1998, after it agreed to merge with its smaller rival, USA Waste Services Inc.

Figure 27: Daily Stock Prices for Waste Management, May 1, 1997–May 29, 1998

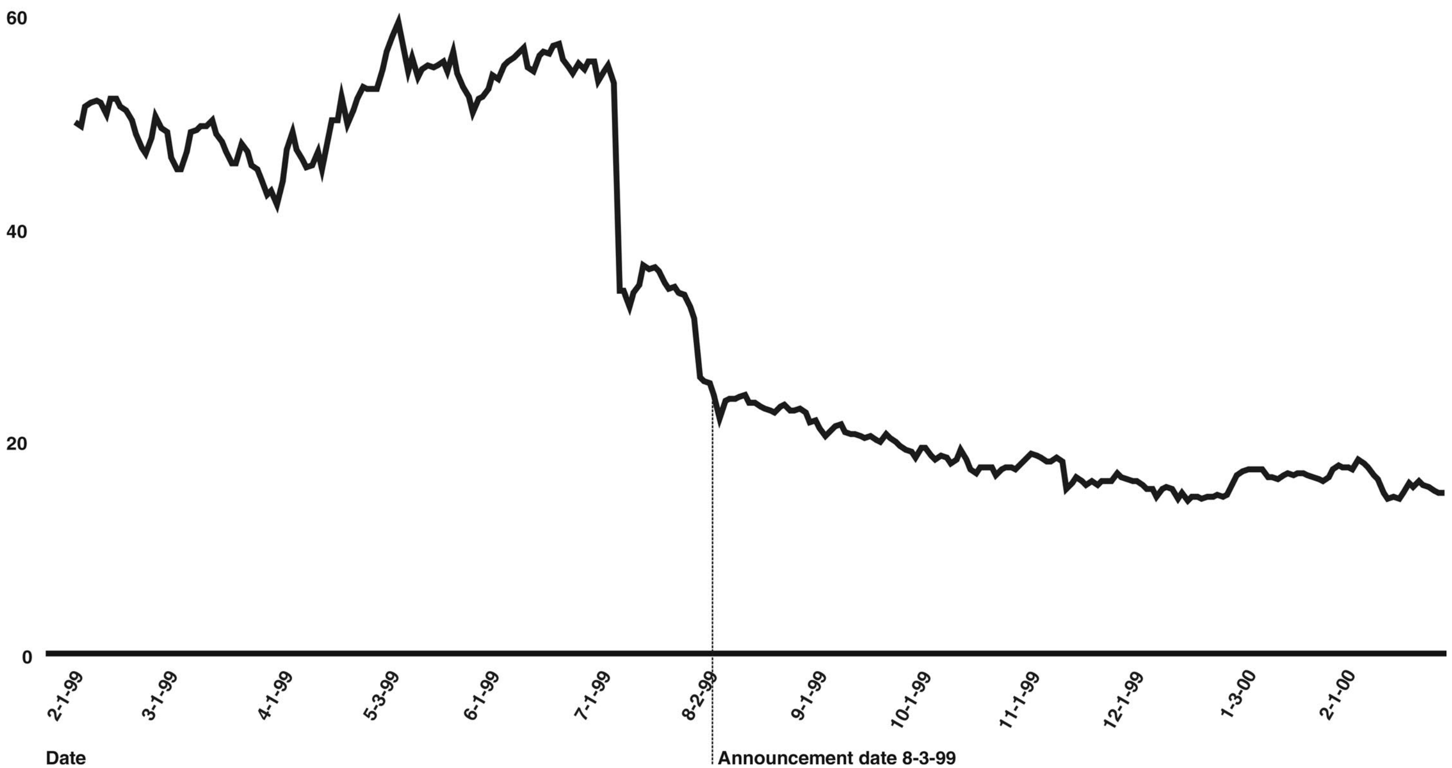


Source: GAO's analysis of NYSE Trade and Quote data.

As with the restatement announced in 1997, the restatement announced in 1999 had relatively little immediate impact on the stock price, as the market had already received bad news from the company related to earnings for the second quarter of 1999 (fig. 28). The restatement announcement on August 3, 1999, was made simultaneously with the

release of scheduled quarterly financial results that met repeatedly lowered expectations. Previously, an earnings warning issued after the close of trading on July 6, 1999, sent the stock price down 37 percent the following day and a second earnings warning on July 29, 1999, drove the stock price down another 17 percent. Over the next few months following the restatement announcement, the stock price drifted lower and then stabilized in the mid-teens.

Figure 28: Daily Stock Prices for Waste Management, February 1, 1999–February 29, 2000



Source: GAO's analysis of NYSE Trade and Quote data.

Securities Analysts' Recommendations

Based on the historical information we were able to obtain, at the time of the initial earnings warning on July 6, 1999, analysts generally had buy recommendations and price targets of $70 to $75 per share to be achieved within 12 months. As late as May 12, 1999, analysts stressed Waste Management's strong cash flow potential. Within weeks of the earnings warning, the stock was downgraded primarily to neutral and hold ratings, and the few remaining buy recommendations were now quoting 12-month price targets of $40 per share.

Credit Rating Agency Actions

Moody's Investors Service, Inc. (Moody's) rated Waste Management's debt. In December 1997 after the first restatement announcement, Moody's confirmed Waste Management's rating as medium-grade. In 1998 after the second restatement announcement, Moody's confirmed Waste Management's credit rating and assigned similar ratings to its other debt throughout the year. In April 1999, Moody's raised the company's long-term debt rating slightly. After the profit warning of July 6, 1999, Moody's confirmed the rating but changed the rating outlook to negative. On July 29, 1999, Moody's downgraded the company's long- and short-term debt to its 1997 levels and left it under review for a possible downgrade.

Legal and Regulatory Actions

SEC has instituted and settled anti-fraud injunctions and improper professional conduct administrative proceedings [Rule 102(e)] against Arthur Andersen and four of its partners. Without admitting or denying the allegations or findings, the firm agreed to pay a $7 million civil penalty and $120,000 for three of the partners named, at that time the largest penalty in an SEC enforcement action against a major accounting firm.

Waste Management agreed to settle a shareholder lawsuit alleging years of questionable accounting practices. On September 7, 2001, it announced a settlement agreement with certain shareholders relating to activity that resulted in the 1998 restatement of the financials, and other issues. This settlement is final and resulted in establishment of a settlement fund for the class of $457 million. Also, SEC recently (March 26, 2002) filed suit against the former management (chairman, CEO, chief operating officer, chief financial officer (CFO), controller, chief accounting officer (CAO), and other senior managers), and charged that the defendants engaged in a systematic scheme to falsify and misrepresent Waste Management's financial results between 1992 and 1997 (list of accused below). The case is still pending.

SEC accused Arthur Andersen of “knowingly or recklessly” issuing false and misleading audit reports for Waste Management for the years 1992 though 1996 that inflated the company’s earnings by more than $1 billion. In each of the years 1992 through 1996, the Arthur Andersen engagement team identified a variety of improper accounting practices that caused Waste Management’s operating and income tax expenses to be understated and its net income to be overstated. While Arthur Andersen quantified some of these misstatements, other known and likely misstatements were not quantified and estimated, as required by generally accepted auditing standards. In connection with the audit of the company’s 1993 financial statements, Arthur Andersen proposed a series of “Action Steps” to change Waste Management’s improper accounting practices only in future periods and to write off its prior misstatements over a 5- to 7- year period, rather than require immediate correction in accordance with generally accepted accounting principles. Ultimately, when the misstatements were revealed, the company announced the largest restatement, at the time, in American corporate history. In issuing an unqualified audit report on the restated financial statements, Andersen acknowledged that the financial statements it had originally audited were materially misstated.

Following is a breakdown of SEC sanctions against Arthur Andersen and its staff:

- Arthur Andersen consented (1) to the entry of a permanent injunction enjoining it from violating Section 10(b) of the Securities Exchange Act of 1934 (Exchange Act) and Rule l0b-5 thereunder; (2) to pay a civil money penalty in the amount of $7 million; and (3) in related administrative proceedings, to a censure pursuant to Rule 102(e) of SEC’s rules of practice, based upon the Commission’s finding that the firm had engaged in improper professional conduct and based also upon the issuance of the permanent injunction;

- Robert E. Allgyer, now retired and then the partner responsible for the Waste Management engagement, consented (1) to the entry of a permanent injunction enjoining him from violating Section 10(b) of the Exchange Act and Rule l0b-5 thereunder and Section 17(a) of the Securities Act of 1933 (Securities Act); (2) to pay a civil money penalty in the amount $50,000; and (3) in related administrative proceedings pursuant to Rule 102(e), to the entry of an order denying him the privilege of appearing or practicing before SEC as an accountant, with the right to request his reinstatement after 5 years;

- Edward G. Maier, currently a partner and then the risk management partner for Arthur Andersen's Chicago office and the concurring partner on the Waste Management engagement, consented (1) to the entry of a permanent injunction enjoining him from violating Section 10(b) of the Exchange Act and rule 10b-5 thereunder and Section 17(a) of the Securities Act; (2) to pay a civil money penalty in the amount $40,000; and (3) in related administrative proceedings pursuant to Rule 102(e), to the entry of an order denying him the privilege of appearing or practicing before SEC as an accountant, with the right to request his reinstatement after 3 years;
- Walter Cercavschi, currently a partner and then a partner on the Waste Management engagement, consented (1) to the entry of a permanent injunction enjoining him from violating Section 10(b) of the Exchange Act and rule 10b-5 thereunder and Section 17(a) of the Securities Act; (2) to pay a civil money penalty in the amount $30,000; and (3) in related administrative proceedings pursuant to Rule 102(e), to the entry of an order denying him the privilege of appearing or practicing before SEC as an accountant, with the right to request his reinstatement after 3 years;
- Robert G. Kutsenda, currently a partner and then the Central Region Audit Practice Director responsible for Arthur Andersen's Chicago, Kansas City, Indianapolis, and Omaha offices (Practice Director), consented in administrative proceedings pursuant to Rule 102(e), to the entry of an order, based on SEC's finding that he engaged in improper professional conduct, denying him the privilege of appearing or practicing before the Commission as an accountant, with the right to request reinstatement after 1 year.

On March 26, 2002, SEC filed suit against Waste Management's former management (chairman; CEO; chief operating officer; CFO; controller; CAO; and other senior managers) and charged that the defendants engaged in a systematic scheme to falsify and misrepresent Waste Management's financial results between 1992 and 1997. SEC's complaint charges that the defendants' improper accounting practices were centralized at corporate headquarters. According to the complaint, each year, Dean L. Buntrock, then CEO, Phillip B. Rooney, then the chief operating officer and others prepared an annual budget in which they set earnings targets for the upcoming year. During the year, they monitored the company's actual operating results and compared them to the quarterly targets set in the budget, according to the complaint. To reduce expenses and inflate earnings artificially, defendants then primarily used "top-level adjustments"

to conform Waste Management's actual results to the predetermined earnings targets, according to the complaint. The inflated earnings of prior periods then became the basis for future manipulations. The complaint charges that, to sustain the scheme, earnings fraudulently achieved in one period had to be replaced in the next.

The complaint alleges that defendants fraudulently manipulated Waste Management's financial results to meet predetermined earnings targets. According to the complaint, the company's revenues were not growing fast enough to meet these targets, so defendants instead resorted to improperly eliminating and deferring current period expenses to inflate earnings. They employed a multitude of improper accounting practices to achieve this objective. Among other things, the complaint charges that the defendants avoided depreciation expenses on their garbage trucks by both assigning unsupported, inflated and arbitrary salvage values and extending the useful lives of garbage trucks. They failed to record expenses for decreases in the value of landfills as they were filled with waste, and refused to record expenses necessary to write off the costs of unsuccessful and abandoned landfill development projects. They established inflated environmental reserves (liabilities) in connection with acquisitions so that the excess reserves could be used to avoid recording unrelated operating expenses. Finally, the complaint alleges, they improperly capitalized a variety of expenses, and failed to establish sufficient reserves (liabilities) to pay for income taxes and other expenses.

The following former Waste Management executives, none of whom is currently with the company, are named in the SEC legal action:[122]

- Mr. Buntrock, Waste Management's founder, chairman of the board of directors, and CEO during most of the relevant period, was accused of being the driving force behind the fraud. According to SEC, he set earnings targets, fostered a culture of fraudulent accounting, personally directed certain of the accounting changes to make the targeted earnings, and was the spokesperson who announced Waste Management's phony numbers. SEC charged that he allegedly was the primary beneficiary of the fraud and reaped more than $16.9 million from, among other things, performance-based bonuses, retirement benefits, charitable giving, and selling Waste Management stock while the fraud was ongoing.

[122]These allegations are not yet proven.

- Mr. Rooney, Waste Management's president and chief operating officer, director, and CEO for a portion of the relevant period, was in charge of building the profitability of the company's core solid waste operations and at all times exercised overall control over the company's largest subsidiary. According to SEC ensured that required write-offs were not recorded and, in some instances, overruled accounting decisions that would have a negative impact on operations. SEC charged that he allegedly reaped more than $9.2 million from, among others things, performance-based bonuses, retirement benefits, and selling company stock while the fraud was ongoing.

- James E. Koenig, Waste Management's executive vice president and CFO, was primarily responsible for executing the scheme. SEC alleges that he also ordered the destruction of damaging evidence, misled the company's audit committee and internal accountants, and withheld information from the outside auditors. SEC charged that he profited by more than $900,000 from his fraudulent acts.

- Thomas C. Hau, Waste Management's vice president, corporate controller, and CAO, allegedly was the principal technician for the fraudulent accounting. According to charges, among other things, he devised many "one-off" accounting manipulations to deliver the targeted earnings and carefully crafted the deceptive disclosures according to the SEC complaint. He profited by more than $600,000 from his fraudulent acts.

- Bruce D. Tobecksen, Waste Management's vice president of finance, was another accounting expert who allegedly was Koenig's right-hand man. In 1994, he was enlisted to assist Hau. He allegedly profited by more than $400,000 from his fraudulent acts.

- Herbert Getz, Waste Management's senior vice president, general counsel, and secretary, allegedly blessed the company's fraudulent disclosures and allegedly profited by more than $450,000 from his fraudulent acts.

SEC alleges that Messrs. Buntrock, Rooney, and Getz violated, or aided and abetted violations of, Section 17(a) of the Securities Act, Sections 10(b) and 13(a) of the Exchange Act, and Exchange Act Rules l0b-5, 12b-20, 13a-1, and 13a-13. SEC further alleges that Messrs. Koenig and Hau violated, or aided and abetted violations of, Section 17(a) of the Securities Act, Sections 10(b), 13(a), 13(b)(2)(A) of the Exchange Act, and Exchange Act

Rules 10b-5, 12b-20, 13a-1, 13a-13, 13b2-1, and 13b2-2. The Commission alleges that Mr. Tobecksen violated, or aided and abetted violations of, Section 17(a) of the Securities Act, Sections 10(b), 13(a), 13(b)(2)(A) of the Exchange Act, and Exchange Act Rules l0b-5, 12b-20, 13a-1, 13a-13, and 13b2-1.

The Commission has requested (1) permanent injunctions against Messrs. Buntrock, Rooney, Koenig, Hau, Getz, and Tobecksen from future violations of, and aiding and abetting future violations of, Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Exchange Act Rule 10b-5 and from aiding and abetting future violations of Section 13(a) of the Exchange Act, and Exchange Act Rules 12b-20, 13a-1, and 13a-13; (2) permanent injunctions against Messrs. Koenig, Hau, and Tobecksen from aiding and abetting future violations of Section 13(b)(2)(A) of the Exchange Act and from future violations of Exchange Act Rule 13b2-1; (3) permanent injunction against Messrs. Koenig and Hau from future violations of Exchange Act Rule 13b2-2; (4) Messrs. Buntrock, Rooney, Koenig, Hau, Getz, and Tobecksen to provide a complete accounting of, and to disgorge, the unjust enrichment realized by them, plus prejudgment interest thereon; (5) that Messrs. Buntrock, Rooney, Koenig, Hau, Getz, and Tobecksen pay civil money penalties pursuant to Section 20(d) of the Securities Act [15 U.S.C. § 77t(d)] and Section 21(d)(3) of the Exchange Act [15 U.S.C. § 78u(d)(3)]; (6) Messrs. Buntrock and Rooney pay civil money penalties pursuant to the Section 21A of the Exchange Act [15 U.S.C. § 78u-1], in the amount of three times their illegal trading profits gained or losses avoided, as described herein; and (7) pursuant to Section 20(c) of the Securities Act [15 U.S.C. § 77t(c)] and Section 21(d)(2) [15 U.S.C. § 78u(d)(2)] of the Exchange Act prohibit Messrs. Buntrock, Rooney, Koenig, Hau, Getz, and Tobecksen from serving as an officer or director of a public company.

Xerox Corporation

Business Overview

Xerox Corporation (Xerox) provides hardware, software, services, and business solutions products. The company's equipment products include multifunctional systems which print, copy, fax and scan as well as printers and copiers for office and production markets. Xerox also provides document outsourcing, network management, and consulting services. For 2001, the company had revenues of $17 billion, a net loss of $71 million, and had about 79,000 employees worldwide.

Restatement Data

On June 16, 2000, Xerox publicly disclosed unexpected provisions in its Mexican business. On June 22, 2000, SEC began an investigation into accounting issues related to Xerox's operations in Mexico. On April 3, 2001, Xerox announced that it was delaying the filing of its year 2000 Form 10-K with the Securities and Exchange Commission (SEC or Commission) due to an independent review begun by Xerox's audit committee in cooperation with Xerox's independent auditor, KPMG LLP. On May 31, 2001, Xerox filed its 2000 Form 10-K with restated consolidated financial statements for the years ending December 31, 1998, and 1999, as a result of two separate investigations conducted by the audit committee of the board of directors. Earnings were restated to reduce 1998 net income by $122 million (30.9 percent) and 1999 net income by $85 million (6 percent). For the 2-year period, Xerox overstated net income by $207 million (11.4 percent).

The two independent investigations focused on the company's operations in Mexico and the company's accounting policies and procedures. As a result, the company determined that certain accounting errors and irregularities had occurred and certain accounting practices misapplied generally accepted accounting principles (GAAP). Xerox found that over a period of years, several senior managers in Mexico had collaborated to circumvent certain of Xerox's accounting policies and administrative procedures. The charge-offs related to provisions for uncollectible long-term receivables, the recording of liabilities for amounts due to concessionaires and, to a lesser extent, for contracts that did not fully meet the requirements to be recorded as sales-type leases. Other items in the restatement were unrelated to Mexico, such as an acquisition reserve.

On April 1, 2002, Xerox announced a settlement in principle with SEC that called for a second restatement of its financial results for 1997 through 2000 as well as an adjustment of previously announced 2001 results (table 24). On June 28, 2002, Xerox restated its consolidated financial statements for the years ending December 31, 1997, 1998, 1999, and 2000, and revised

its previously announced 2001 results. For 1997, net income decreased by $466 million (34.3 percent), 1998 net income decreased by $440 million (161.2 percent), 1999 net income decreased by $495 million (37 percent), and 2000 net loss increased by $16 million (6.2 percent). For the 4-year period, Xerox overstated net income by $1.42 billion (52.3 percent). Once again, Xerox determined that certain of its accounting practices misapplied GAAP. The restatements primarily reflected expense recognition and adjustments in the timing and allocation of revenue from bundled leases, which needed to be reallocated among equipment, service, supplies and finance revenue streams as appropriate by applying a methodology different than the one Xerox had used during previous years.

Table 24: Selected Financial Data, 1997–2000

Dollars in millions

	Fiscal years			
Affected financial data	**1997**	**1998**	**1999**	**2000**
Revenue, as reported	$18,225	$19,593	$19,567	$18,701
Revenue, as restated	17,457	18,777	18,995	18,751
Net income (loss), as reported	1,359	273	1,339	(257)
Net income (loss), as restated	893	(167)	844	(273)

Source: SEC filings.

Accounting/Audit Firm

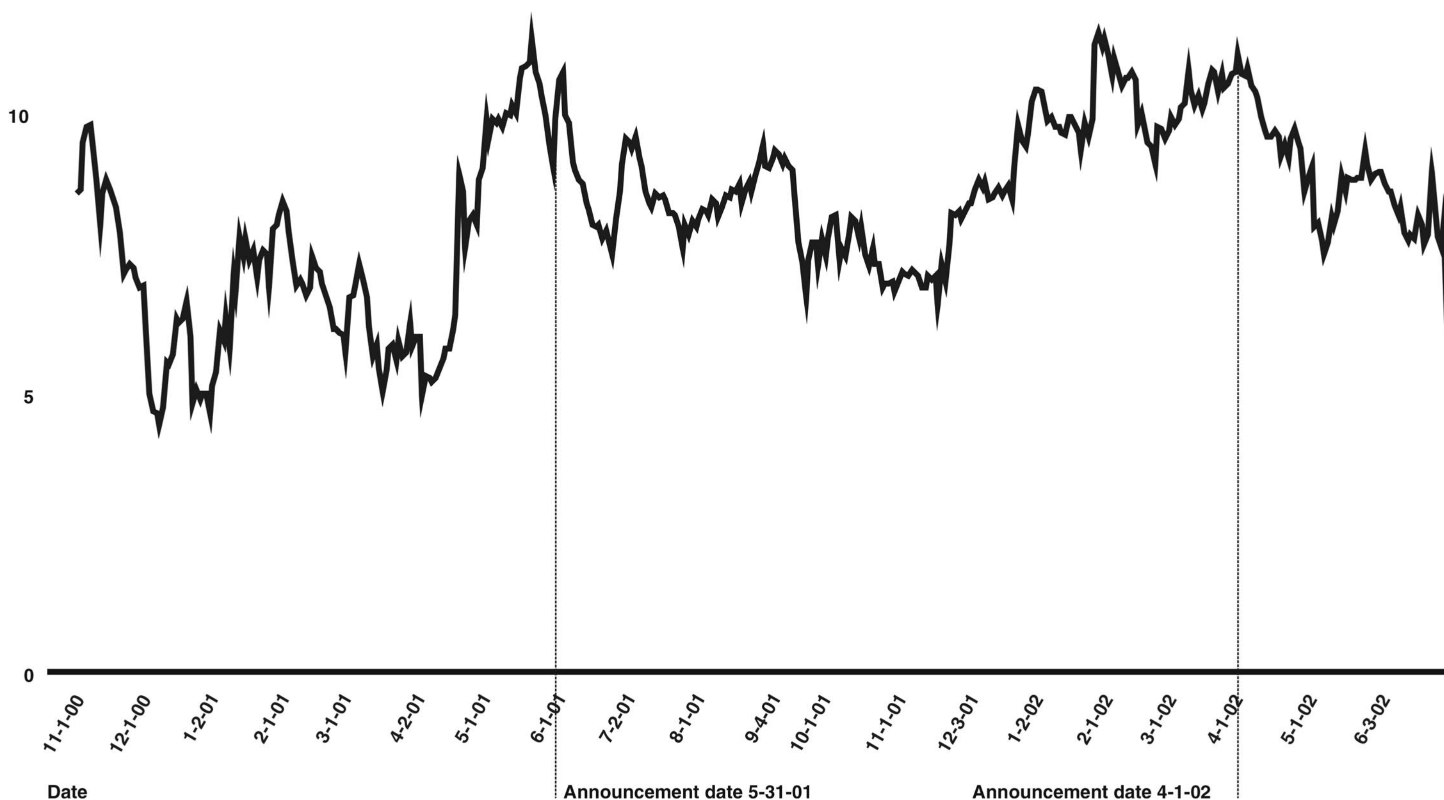
KPMG LLP was the independent auditor until October 4, 2001, when Xerox hired PricewaterhouseCoopers LLP (PwC) as its independent accountant. Prior to October, KPMG LLP and Xerox had a long relationship. Currently, KPMG LLP and at least two of its partners on the Xerox account are subjects of an SEC investigation looking into their roles in the financial restatement process. KPMG LLP also faces shareholder lawsuits over its role in approving the accounting that Xerox and its new accountant, PwC, rejected on June 28, 2002.

Stock Price

Xerox stock is listed on the New York Stock Exchange (NYSE) and trades under the ticker symbol XRX. Despite its April 3, 2001, announcement, shares of Xerox stock price began a sharp ascent from early April through May 2001. In mid-April the company announced fiscal first quarter results that beat analyst estimates and further stated that its turnaround and restructuring strategy was effective. During this period, the stock price climbed from under $5 to over $11 (fig. 29). On May 31, 2001, Xerox announced a restatement but also stated that no fraud had been discovered and the company's liquidity would not be impacted. Shares rose nearly 10 percent to $9.91. By early September 2001, shares were trading around $9 per share.

At the beginning of March 2002, Xerox stock was trading near $10 per share. When Xerox announced a second restatement on April 1, 2002, the stock price peaked at $11.08, up 3 percent on the day. Xerox stock price subsequently declined, along with the overall market, through June 2002, closing at $6 on June 28, 2002.

Figure 29: Daily Stock Prices for Xerox, November 1, 2000-June 28, 2002



Source: GAO's analysis of NYSE Trade and Quote data.

Securities Analysts' Recommendations

Based on historical analyst research information we identified, we found 8 out of 11 securities analysts researching Xerox issued "strong buy" recommendations. Buy recommendations continued throughout most of 1999. However, on October 9, 1999, Xerox warned that its earnings would be lower than expected. The same day, the stock price dropped 24 percent and several analysts downgraded their earnings estimates for 1999 and 2000.

On December 14, 1999, Xerox warned that fourth quarter earnings would fall short of expectations. Although the stock price dropped another 14 percent and many more analysts downgraded their recommendations, not all analysts lowered their recommendations. For example, one analyst reiterated her buy recommendation and predicted that the share price would hit $41 within the next 18 months. Xerox stock closed the day at $20.06 per share.

As the stock price continued to fall, closing at $8.94 on October 24, 2000, and almost half that at $4.69 on December 5, 2000, 10 of the 11 analysts who followed Xerox had “hold” ratings on the stock. On June 28, 2002, at the time of the second restatement and with the stock price at $6.97, there was still only one “sell” recommendation on Xerox stock.

Credit Rating Agency Actions

Moody’s Investors Service, Inc. (Moody’s) and Standard and Poor’s rate Xerox’s debt. After confirming the credit ratings of certain of Xerox’s debt in September 1999, Moody’s placed Xerox under review for possible downgrade in December following its October 1999 early warning. In April 2000, Moody’s lowered Xerox’s rating and considered its outlook stable. However, in July 2000, Xerox was placed under review for another possible downgrade. Likewise, Standard and Poor’s credit watch was negative. In September 2000, Moody’s and Standard and Poor’s lowered their rating for Xerox. In the following month, Moody’s announced that Xerox’s ratings had been placed under review for a possible downgrade while Standard and Poor’s lowered Xerox’s long-term debt rating. In December 2000, Moody’s lowered the company’s debt rating and considered its outlook negative. In March 2001, Moody’s confirmed Xerox’s rating. In October 2001, Standard and Poor’s lowered its long-term rating once again. By January 2002, Moody’s placed Xerox’s rating under review for a possible downgrade while Standard and Poor’s lowered the rating in April, several weeks after the second restatement announcement. Moody’s lowered its rating of Xerox in May 2002. In June 2002, Standard and Poor’s lowered Xerox’s long-term rating once again.

Legal and Regulatory Actions Taken

A consolidated securities law action (consisting of 17 cases) is pending in the U.S. District Court for the District of Connecticut. Defendants are the company, Barry Romeril, Paul Allaire and G. Richard Thoman. The consolidated action is a class action on behalf purchasers of Xerox common stock during the period between October 22, 1998, through

October 7, 1999. The complaint in the action alleges that in violation of Section 10(b) and/or 20(a) of the Securities Exchange Act of 1934 (Exchange Act) and Rule 10b-5 thereunder, each of the defendants fraudulently disseminated materially false and misleading statements and/or concealed material facts. The parties are engaged in discovery.

A second consolidated securities law action Carlson vs. Xerox Coporation et al. (consisting of 21 cases), is pending in the U.S. District Court for the District of Connecticut against the company, KPMG LLP, and Paul A. Allaire, G. Richard Thoman, Anne M. Mulcahy, Barry D. Romeril, Gregory Tayler and Philip Fishbach. The consolidated action purports to be a class action on behalf of the named plaintiffs and all purchasers of securities of, and bonds issued by, Xerox during the period between February 17, 1998, through February 6, 2001. Among other things, the second consolidated amended complaint, filed on February 11, 2002, generally alleges that each of the defendants violated Section 10(b) of the Exchange Act and Rule 10b-5 thereunder. The individual defendants are also allegedly liable as "controlling persons" of the company pursuant to Section 20(a) of the Exchange Act. Plaintiffs claim that the defendants fraudulently disseminated materially false and misleading statements and/or concealed material adverse facts relating to the company's Mexican operations and other matters relating to the company's accounting practices and financial condition. On May 6, 2002, Xerox and the individual defendants filed a motion to dismiss the second consolidated amended complaint. KPMG LLP filed a separate motion to dismiss. According to Xerox, the plaintiffs have indicated that they intend to file a third amended complaint.

On January 4, 2002, the Florida State Board of Administration, the Teachers' Retirement System of Louisiana, and Franklin Mutual Advisers filed an action in the U. S. District Court for the Northern District of Florida against the company, Paul Allaire, G. Richard Thoman, Barry Romeril, Anne Mulcahy, Philip Fishbach, Gregory Tayler, Eunice M. Filter and KPMG LLP. The plaintiffs allege that each of the defendants and KPMG LLP violated Sections 10(b) and 18 of the Exchange Act, Rule 10b-5 thereunder, the Florida Securities Investors Protection Act, Fl. Stat. § 517.301, and the Louisiana Securities Act, R.S. 51:712(A). The plaintiffs further claim that the individual defendants are each liable as "controlling persons" of the company pursuant to Section 20 of the Exchange Act and that each of the defendants is liable for common law fraud and negligent misrepresentation. The complaint generally alleges that the defendants deceived the investing public by disseminating materially false and misleading statements and/or concealing material adverse facts relating to

the company's Mexican operations and other matters relating to the company's financial condition and accounting practices. This case was transferred to the U.S. District Court for the District of Connecticut for consolidation or coordination for pretrial purposes with the previously described 21 consolidated actions currently pending there under the caption, Carlson v. Xerox et al. According to Xerox, the plaintiffs have indicated that they intend to file an amended complaint.

On July 1, 2002, a class-action complaint was filed in the U. S. District Court for the District of Connecticut alleging violations of the Employee Retirement Income Security Act (ERISA). The named plaintiff, Thomas Patti, is a Xerox employee who alleges he is a participant in the Xerox Corporation Profit Sharing and Savings Plan (Plan) who invested or maintained investments in the Xerox stock fund during the proposed class period, February 15, 1998 to the present. He seeks to represent a class of individuals similarly situated, which he claims exceeds 50,000 persons. The defendants include Xerox, the Plan (as a nominal defendant only) and the following individuals or groups of individuals during the proposed class period: the Plan Administrator, the Plan's administrative committee, the board of directors, the finance committee of the board of directors, and the treasurer. The complaint claims that all of the defendants were fiduciaries of the Plan under ERISA and, as such, were obligated to protect the Plan's assets and act in the best interest of Plan participants. The complaint alleges that the defendants failed to do so and thereby breached their fiduciary duties. The complaint sets out four separate ERISA causes of action. Specifically, he claims that the defendants failed to provide accurate and complete material information to participants concerning Xerox stock, including accounting practices which allegedly artificially inflated the value of the stock, and misled participants regarding the soundness of the stock and the prudence of investing retirement benefits in Xerox stock. The plaintiff also claims that the defendants failed to ensure that Plan assets were invested prudently, to monitor the other fiduciaries and to disregard Plan directives they knew or should have known were imprudent.

A consolidated putative shareholder derivative action is pending in the Supreme Court of the State of New York against several current and former members of the board of directors, including William F. Buehler, B.R. Inman, Antonia Johnson, Vernon E. Jordan, Jr., Yotaro Kobayashi, Hilmar Kopper, Ralph Larsen, George J. Mitchell, N.J. Nicolas, Jr., John E. Pepper, Patricia Russo, Martha Seger, Thomas C. Theobald, Paul Allaire, G. Richard Thoman, Anne Mulcahy and Barry Romeril, and KPMG LLP. The plaintiffs

brought this action in the name of and for the benefit of the company, which is named as a nominal defendant, and its public shareholders.

The complaint alleges that each of the director defendants breached his or her fiduciary duties to Xerox and its shareholders by, among other things, ignoring indications of a lack of oversight at the company and the existence of flawed business and accounting practices within Xerox's Mexican and other operations; failing to have in place sufficient controls and procedures to monitor the company's accounting practices; knowingly and recklessly disseminating and permitting to be disseminated, misleading information to shareholders and the investing public; and permitting Xerox to engage in improper accounting practices. The plaintiffs also allege that each of the director defendants breached his/her duties of due care and diligence in the management and administration of Xerox's affairs and grossly mismanaged or aided and abetted the gross mismanagement of Xerox and its assets. The complaint also asserts claims of negligence, negligent misrepresentation, breach of contract and breach of fiduciary duty against KPMG LLP. Additionally, plaintiffs claim that KPMG LLP is liable to Xerox for contribution, based on KPMG LLP's share of the responsibility for any injuries or damages for which Xerox is held liable to plaintiffs in related pending securities class-action litigation. On behalf of the company, the plaintiffs seek a judgment declaring that the director defendants violated and/or aided and abetted the breach of their fiduciary duties to Xerox and its shareholders.

On May 16, 2002, a shareholder derivative action was brought in U.S. District Court for the District of Connecticut against KPMG LLP. The company was named as a nominal defendant. The plaintiff purported to bring this action derivatively in the right, and for the benefit, of Xerox. He contended that he is excused from complying with the prerequisite to make a demand on the Xerox board of directors, and that such demand would be futile, because the directors are disabled from making a disinterested, independent decision about whether to prosecute this action. In the original complaint, plaintiff alleged that KPMG LLP, Xerox's former outside auditor, breached its duties of loyalty and due care owed to Xerox by repeatedly acquiescing in, permitting and aiding and abetting the manipulation of Xerox's accounting and financial records in order to improve the company's publicly reported financial results. He further claimed that KPMG LLP committed malpractice and breached its duty to use such skill, prudence and diligence as other members of the accounting profession commonly possess and exercise. The plaintiff claimed that as a result of KPMG LLP's breaches of duties, Xerox has suffered loss and

damage. On May 29, 2002, the plaintiff amended the complaint to add as defendants the present and certain former directors of Xerox. He added claims against each of them for breach of fiduciary duty, and separate additional claims against the directors who are or were members of the audit committee of the board of directors, based upon the alleged failure, inter alia, to implement, supervise and maintain proper accounting systems, controls and practices.

On June 6, 2002, a shareholder, Stanley Lerner, commenced a derivative action in the U. S. District Court for the District of Connecticut against Messrs. Allaire, Buehler, Romeril, G. Thoman, and Ms. Mulcahy. The plaintiff purports to bring the action derivatively, on behalf of Xerox, which is named as a nominal defendant. The plaintiff alleges that the individual defendants breached their fiduciary duties of care and loyalty by disguising the true operating performance of Xerox through improper undisclosed accounting mechanisms between 1997 and 2000.

On June 22, 2000, SEC began an investigation of accounting issues related to Xerox's Mexican business. On April 11, 2002, SEC and Xerox concluded a settlement, as a result of which SEC filed a civil complaint alleging that from at least 1997 through 2000, Xerox used a variety of undisclosed accounting actions to meet or exceed Wall Street's expectations and disguise its true operating performance from investors. The complaint alleges that "in a scheme directed and approved by its senior management, Xerox disguised its true operating performance by using undisclosed accounting maneuvers—most of which were improper—that accelerated the recognition of equipment revenue by over $3 billion and increased earnings by approximately $1.5 billion." According to SEC's complaint, Xerox engaged in a variety of accounting violations, including

- Accelerating leasing revenue—Xerox allegedly repeatedly changed the way it accounted for lease revenue but failed to disclose that the associated gains were the result of accounting changes rather than improved operating performance. Moreover, many of the practices used failed to comply with GAAP. For example, Xerox used a return on equity allocation method that involved calculating the estimated fair value of the equipment as the portion of the lease payments remaining after subtracting the estimated fair value of the services and financing components. As the estimated fair value of services and financing declined, the equipment sales revenue that was recognized immediately increased. Xerox was also accused of accelerating the recognition of revenues by immediately recognizing as the revenue price increases and

extensions of existing lease rather than recognizing the increases over the remaining life of the lease.

- Improper increases in residual values of leased equipment—Xerox allegedly adjusted the estimated residual value of leased equipment (that is, its remaining value at the end of the lease term) after the inception of the lease in violation of GAAP. SEC alleges that this write-up in the residual value of equipment was used to credit the cost of sales, were recorded close to the end of quarterly reporting periods as "a gap-closing measure to help Xerox meet or exceed internal and external earnings and revenue expectations."

- Acceleration of revenues from portfolio asset strategy transactions—selling investors the revenue streams from portfolios of its leases that otherwise would not have allowed for immediate revenue recognition. SEC alleges that Xerox used these transactions to recognize revenue that would have otherwise been recognized in future periods and failed to disclose this practice.

- Fraudulent manipulation of reserves and other income—Xerox allegedly increased its earnings by releasing excess reserves that were originally established for some other purpose into income in violation of GAAP. Xerox also allegedly systematically released a gain associated with the successful resolution of a dispute with the Internal Revenue Service to improperly increase earnings from 1997 through 2000. Although GAAP required that the entire gain be recognized upon the completion of all legal contingencies in 1995 and 1996, Xerox used most of it to meet its earnings targets.

- Failure to disclose factoring transactions—Xerox allegedly failed to disclose factoring transactions that allowed it to report a positive year-end cash balance, instead of a negative one. This factoring involved Xerox selling its receivables at a discount in order to realize instant cash instead of a future stream of cash. According to SEC complaint, analysts looked to Xerox to increase its liquidity and called for stronger end-of-year cash balances in 1999. Unable to generate cash, Xerox management instructed its largest operating units to explore the possibility of engaging in factoring transactions with local banks. These transactions materially affected Xerox's 1999 operating cash flows but these transactions were not disclosed in its 1999 financial statements. In some of the factoring transactions involved buy-back agreements in which Xerox would reacquire the receivables after the end of the year. By

accounting for these transactions as true sales, Xerox violated GAAP. Not only did Xerox fail to disclose the agreements, it failed to reverse them in the next year.

Without admitting or denying the allegations of the complaint, Xerox consented to a final judgment that includes a permanent injunction from violating the antifraud, reporting and recordkeeping provisions of the federal securities laws, specifically Section 17(a) of the Securities Act of 1933 and Sections 10(b), 13(a), 13(b)(2)(A) and 13(b)(2)(B) of the Exchange Act and Rules 10b-5, 13a-1. 13a-13, 12b-20 and 13b2-1 promulgated thereunder. In addition, Xerox agreed to restate its financials for the years 1997 through 2000 and pay a $10 million civil penalty. As part of this agreement, Xerox also agreed to have its board of directors review the company's material internal accounting controls and policies.

Listing of Accounting and Auditing Enforcement Releases (AAER)

Table 25: Listing of AAER Cases, January 2001-June 2002

Number	Date of release	SEC AAER number[a]	Case description
1	1/4/2001	1358	ITMO[b] Transcrypt International, Inc.
2	1/17/2001	1359	ITMO Mark Steven Lynch, CPA
3	1/19/2001	1360	ITMO KPMG Peat Marwick LLP
4	1/23/2001	1361	SEC v. Aurora Foods, Inc., et al.
5	1/24/2001	1362	ITMO Linda Mueller
6	1/25/2001	1363	ITMO Swart, Baumark & Co., LLP and Harry J.Swart, CPA
7	1/31/2001	1364	ITMO Charles P. Morrison, CPA
8	1/31/2001	1365	SEC v. David W. McConnell and Charles P. Morrison
9	2/5/2001	1366	ITMO SecureSign, Inc.
10	2/5/2001	1367	SEC v. Jeffrey. Fuller, Rebecca L. Schultz, and C. Eric Baumann
11	2/7/2001	1368	ITMO Isaac Hager
12	2/6/2001	1369	SEC v. Martin R. Frankel, John A. Hackney, Robert J. Guyer, Liberty National Securities, Inc., Gary Atnip, and Sonia Howe Radencovici
13	2/14/2001	1370	ITMO Computron Software, Inc., n/k/a/ AXS-One Inc.
14	2/14/2001	1371	ITMO Michael Ford, CPA
15	2/28/2001	1372	SEC v. Walter A. Forbes and E. Kirk Shelton
16	2/28/2001	1373	SEC v. Vigue et al.
17	3/8/2001	1374	ITMO KPMG Peat Marwick LLP
18	3/2/2001	1375	SEC v. Amazon Natural Treasures, Inc., Michael A. Sylver, and Domingos Loricchio, Jr.
19	3/12/2001	1376	ITMO Kevin E. Orton, CPA
20	3/14/2001	1377	ITMO Kevin E. Orton, CPA, and Orton & Company
21	3/29/2001	1378	ITMO National Steel Corporation
22	3/30/2001	1379	ITMO Carl M. Apel
23	3/30/2001	1380	SEC v. Montedsion, S.p.A.
24	4/16/2001	1381	SEC v. John N. Brincat and Bradley Vallem
25	4/17/2001	1382	SEC v. Excal Enterprises, Inc., et al.
26	4/18/2001	1383	ITMO Bruce J. Kingdon, Kenneth Goglia, and Harvey Plante
27	4/18/2001	1384	SEC v. Bruce J. Kingdon, Kenneth Goglia, and Harvey Plante
28	4/26/2001	1385	SEC v. Alexandra Elizabeth Montgomery, William Kenneth Nestor, and Harriet Gluck
29	4/27/2001	1386	ITMO Arden Franklin, CPA
30	5/1/2001	1387	ITMO Joseph Bevaqua, CPA
31	5/2/2001	1388	ITMO Pat A. Rossetti, CPA
32	5/4/2001	1389	ITMO Barry C. Scutillo, CPA, Mark F. Jensen, CPA, and R. Gordon Jones, CPA
33	5/4/2001	1390	ITMO R. Gordon Jones, CPA and Mark F. Jensen, CPA

(Continued From Previous Page)

Number	Date of release	SEC AAER number[a]	Case description
34	5/7/2001	1391	ITMO Craig R. Clark, CPA
35	5/7/2001	1392	SEC v. Jerry M. Walker & Craig R. Clark
36	5/15/2001	1393	ITMO Sunbeam Corporation
37	5/15/2001	1394	ITMO David C. Fannin
38	5/15/2001	1395	SEC v. Albert J. Dunlap, Russel A. Kersh, Robert J. Gluck, Donald R. Uzzi, Lee B. Griffith, and Phillip E. Harlow
39	5/15/2001	1396	SEC v. Allan Boren
40	5/16/2001	1397	ITMO Microtest, Inc.
41	5/23/2001	1398	SEC v. Walter Konigseder
42	5/24/2001	1399	ITMO Prime Capital Corporation
		1400	Omitted
43	6/5/2001	1401	ITMO Am-Pac International, Inc.
44	6/4/2001	1402	ITMO James M. Cassidy and TPG Capital Corporation
45	6/5/2001	1403	SEC v. Am-Pac International, Inc., Thomas L. Tedrow, and Jeffrey D. Martin
46	6/14/2001	1404	ITMO James Thomas McCurdy, CPA
47	6/19/2001	1405	ITMO Arthur Andersen, LLP
48	6/19/2001	1406	ITMO Robert E. Allgyer, CPA
49	6/19/2001	1407	ITMO Edward G. Maier, CPA
50	6/19/2001	1408	ITMO Walter Cercavschi, CPA
51	6/19/2001	1409	ITMO Robert G. Kutsenda, CPA
52	6/19/2001	1410	SEC v. Arthur Andersen, LLP, Robert E. Allgyer, Walter Cercavschi, and Edward G. Maier
53	6/20/2001	1411	SEC v. Ron Messenger, James T. Rush, Scott K. Barton, and Gary Hubschman
54	6/21/2001	1412	ITMO Michael J. Becker
55	6/21/2001	1413	ITMO J. Allen Seymour, CPA
56	6/21/2001	1414	SEC v. Richard P. Smyth, Arnold E. Johns, Jr., Michael J. Becker, and Alan T. Davis
57	6/19/2001	1415	ITMO Albert Glenn Yesner
58	6/25/2001	1416	ITMO American Classic Voyages Co.
59	7/2/2001	1417	ITMO Scott K. Barton, CPA
60	7/2/2001	1418	ITMO James T. Rush
61	7/3/2001	1419	SEC v. Mar-Jeanne Tendler, Arthur Tendler, and Billie M. Jolson
62	7/3/2001	1420	ITMO SecureSign, Inc., (formerly Yourbankonline.com), Pakie V. Plastino, and William L. Butcher, CPA
63	7/3/2001	1421	ITMO SecureSign, Inc., (formerly Yourbankonline.com), Pakie V. Plastino, and William L. Butcher, CPA
64	7/18/2001	1422	ITMO American Bank Note Holographics, Inc.
65	7/18/2001	1423	ITMO John Lerlo
66	7/18/2001	1424	ITMO Mark Goldberg, CPA

(Continued From Previous Page)

Number	Date of release	SEC AAER number[a]	Case description
67	7/18/2001	1425	SEC v. Morris Weissman, Joshua Cantor, John Gorman, Patrick Gentile, American Banknote Corporation, American Bank Note Holographics, Inc, Richard Macchiarulo, Antonio Accornero and Russel McGrane
68	7/20/2001	1426	ITMO Richard P. Macchiarulo, CPA
69	7/23/2001	1427	SEC v. Edward J. Kiley and Richard N. Orzechowski
70	7/27/2001	1428	ITMO Jeffrey M. Yonkers, CPA
71	7/30/2001	1429	ITMO BankAmerica Corporation, n/k/a/ Bank of America Corporation
72	8/1/2001	1430	ITMO MAX Internet Communications, Inc.
73	8/1/2001	1431	SEC v. William F. Buettner, Mark D. Kistein, and Amy S. Fraizer
74	8/1/2001	1432	SEC v. Larry Biggs, Jr., Donald McLellan, and Leslie D. Crone
75	8/13/2001	1433	SEC v. Richard I. Berger & Donna M. Richardson
76	8/16/2001	1434	ITMO Leslie D. Crone, CPA
77	9/4/2001	1435	ITMO Salvatore T. Marino, CPA
78	9/5/2001	1436	SEC v. Peter T. Caserta, Salvatore Marino, and Dana C. Verrill
79	9/5/2001	1437	ITMO Indus International, Inc.
80	9/5/2001	1438	ITMO Carl Albano
81	9/5/2001	1439	SEC v. William Grabske, Robert Pocsik, and Ralph Widmaier
82	9/6/2001	1440	SEC v. M&A West, Scott L. Kelly, Salvatore Censoprano, Zahra R. Gilak, Frank Thomas Eck, III, and Stanley R. Medley
83	9/10/2001	1441	ITMO Walter Thompson Reeder
84	9/10/2001	1442	ITMO George Kelly Moore, CPA
85	9/10/2001	1443	SEC v.Patrick Swisher and Swisher International, Inc.
86	9/12/2001	1444	ITMO Baker Hughes, Incorporated
87	9/12/2001	1445	SEC v. Eric L. Mattson and James W. Harris
88	9/12/2001	1446	SEC v. KPMG Siddharta Siddharta & Harsono and Sonny Harsono
89	9/17/2001	1447	ITMO Robert M. Fuller
90	9/19/1931	1448	SEC v. CEC Industries Corporation, Greald H. Levine, and Marie A. Levine
91	9/19/2001	1449	ITMO Madera International, Inc.
92	9/19/2001	1450	ITMO Regina Fernandez
93	9/19/2001	1451	ITMO Ralph Sanchez, CPA
94	9/19/2001	1452	ITMO Harlan & Boettger, LLP, William C. Boettger, CPA, and P. Robert Wilkenson, CPA
95	9/19/2001	1453	SEC v. Madera International, Inc., Ramiro M. Fernandez-Moris, Daniel S. Lezak, and Regina Fernandez
96	9/25/2001	1454	SEC v. Gunther International, Ltd.
97	9/26/2001	1455	SEC v. John Daws, Thomas Butler, and Mark Folit
98	9/27/2001	1456	ITMO Charles K.Springer, CPA, Robert S. Haugen, CPA, and Haugen, Springer & Co., PC

(Continued From Previous Page)

Number	Date of release	SEC AAER number[a]	Case description
99	9/27/2001	1457	ITMO Joseph H. Kiser
100	9/27/2001	1458	SEC v. Stephen L. Holden, Scott P. Skooglund, Kuldarshan S. Padda, and Stephan C. Beal
101	9/27/2001	1459	ITMO Paul S. Jurewicz
102	9/27/2001	1460	SEC v. Vari-L Company, Inc., David G. Sherman, Jon L. Clark, and Sarah E. Hume
103	9/28/2001	1461	SEC v. Matthew R. Welch and James C. Horne
104	10/2/2001	1462	SEC v. Millionaire.com and Robert White
105	10/3/2001	1463	ITMO Chiquita Brands International, Inc.
106	10/3/2001	1464	SEC v. Chiquita BrandsInternational, Inc.
107	10/4/2001	1465	SEC v. Roys Poyiadjis, Lycourgos Kyprianou and AremisSoft Corp.
108	10/5/2001	1466	SEC v. Richard P.Smyth, Arnold E. Johns, Jr., Michael J. Becker, and Alan T. Davis
109	10/15/2001	1467	SEC v. Jay Lapine, Michael Smeraski, Timothy Heyerdahl, Deborah Mattiford, Elaine Decker, and David Held
110	10/17/2001	1468	SEC v. Millionaire.com and Robert White
111	10/18/2001	1469	ITMO NexPub, Inc. (formerly known as PrintontheNet.com, Inc.)
112	10/23/2001	1470	21(a) Report
113	10/23/2001	1471	SEC v. Gisela de Leon-Meredith
114	10/25/2001	1472	SEC v. Hollywood Trenz, Inc., Edward R. Showalter, Tracy A. Braime, and Robert E. Burton, Jr.
115	10/29/2001	1473	SEC v. Roys Poyiadjis, Lycourgos Kyprianou and AremisSoft Corp.
116	10/30/2001	1474	SEC v. Richard P.Smyth, Arnold E. Johns, Jr., Michael J. Becker and Alan T. Davis
117	11/29/2001	1475	SEC v. Maurice B. Newman and Richard A. Gerhart
118	12/6/2001	1476	ITMO Pinnacle Holdings, Inc.
119	12/7/2001	1477	SEC v. Digital Lightwave, Inc. and Bryan J. Zwan
120	12/14/2001	1478	ITMO Corrine Davies
121	12/14/2001	1479	ITMO Timothy Tuttle
122	12/27/2001	1480	SEC v. Nelson Barber
123	12/27/2001	1481	ITMO Rachel Eckhaus, CPA
124	12/27/2001	1482	ITMO Jeffrey Bacsik, CPA
125	12/27/2001	1483	ITMO Barbara Horvath, CPA
126	1/2/2002	1484	SEC v. R. Bruce Acacio
127	1/3/2002	1485	ITMO Financial Asset Management Inc., James B. Rader, and Debra L. Kennedy
128	1/7/2002	1486	ITMO California Software Corporation
129	1/7/2002	1487	ITMO Carol Conway Dewees
130	1/7/2002	1488	ITMO James E.Slayton
131	1/8/2002	1489	SEC v. David C. Guenthner and Jay M.Samuelson
132	1/11/2002	1490	ITMO Michael Marrie, CPA & Brian Berry, CPA

(Continued From Previous Page)

Number	Date of release	SEC AAER number[a]	Case description
133	1/14/2002	1491	ITMO KPMG, LLP
134	1/14/2002	1492	SEC v. R. Bruce Acacio
135	1/14/2002	1493	SEC v. Michael A. Porter - AA forgery
136	1/15/2002	1494	ITMO BellSouth Corporation
137	1/15/2002	1495	SEC v. BellSouth Corporation
138	1/15/2002	1496	ITMO Nelson Barber, CPA
139	1/15/2002	1497	SEC v. William P. Trainor, Vincent D. Celentano, Medical Diagnostic Products, Inc. (f/k/a Novatek International, Inc.), Karen Losordo, Diane M. Trainor, Daniel J. Trainor, Geraldine Trainor and Mary N. Celentano
140	1/15/2002	1498	SEC v. Nelson Barber
141	1/16/2002	1499	ITMO Trump Hotels & Casino Resorts, Inc.
142	1/16/2002	1500	SEC v. Thomas W. Lambach
143	1/30/2002	1501	ITMO Cyberguard Corporation, William D. Murray, and Tommy D. Steele
144	1/30/2002	1502	SEC v. Patrick O. Wheeler, Steven S. Gallers, and Robert L. Carberry
145	2/5/2002	1503	ITMO Critical Path, Inc.
146	2/5/2002	1504	SEC v. David A. Thatcher and Timothy J. Ganley
147	2/13/2002	1505	ITMO William H. Warner and Robert J. Quigley
148	2/14/2002	1506	SEC v. International Thoroughbred Breeders, Inc., and Nunzio DeSantis
149	2/20/2002	1507	ITMO JDN Realty Corporation
150	2/20/2002	1508	SEC v. J. Donald Nichols, Jeb L. Hughes, and C. Sheldon Whittelsey IV
151	3/1/2002	1509	SEC v. Eagle Building Technologies, Inc. and Anthony Damato
152	3/5/2002	1510	ITMO Kevin R. Andersen, CPA
153	3/5/2002	1511	ITMO Telxon Corporation, Gary, L. Grand,and James G. Cleveland
154	3/5/2002	1512	SEC v. Kenneth W. Haver
155	3/6/2002	1513	ITMO James E. Slayton, CPA
156	3/6/2002	1514	SEC v. Raece Richardson, David McKenzie, Cameron Gorges, and Freestar Technologies
157	3/6/2002	1515	SEC v. American Telephone + Data, Inc., William Posnett Lynas, III, Janeen Hauxhurst-Lynas, and Daniel W. Kratochvil
158	3/12/2002	1516	SEC v. Paul Skulsky, et al.
159	3/12/2002	1517	ITMO Frederick W. Kolling III, CPA
160	3/12/2002	1518	ITMO William A. Dickson and Stephen P. Collins
161	3/12/2002	1519	ITMO Donald J. MacPhee
162	3/12/2002	1520	ITMO IGI, Inc.
163	3/13/2002	1521	SEC v. John P. Gallo
164	3/18/2002	1522	ITMO Timothy S. Heyerdahl, CPA
165	3/18/2002	1523	ITMO David Held, CPA
166	3/18/2002	1524	ITMO Elaine A. Decker, CPA

(Continued From Previous Page)

Number	Date of release	SEC AAER number[a]	Case description
167	3/20/2002	1525	ITMO Lisa M. Beuche, CPA
168	3/21/2002	1526	ITMO Keith Spero
169	3/21/2002	1527	ITMO Frank Valdez
170	3/21/2002	1528	ITMO Harlan Schier
171	3/21/2002	1529	ITMO Daniel Parker
172	3/21/2002	1530	ITMO Uri Evan, Joseph S. Cohen, and Frederick J. Horowitz
173	3/21/2002	1531	SEC v. Harold J. Macsata
174	3/26/2002	1532	SEC v. Dean L. Buntrock, Phillip B. Rooney, James E. Koenig, Thomas C. Hau, Herbert A. Getz, and Bruce D. Tobecksen
175	3/27/2002	1533	ITMO Kimberly-Clark Corporation and John W. Donehower
176	3/27/2002	1534	ITMO Signal Technology Corporation
177	3/27/2002	1535	SEC v. Dale Peterson et al.
178	3/28/2002	1536	ITMO PictureTel Corp. and Les B. Strauss
179	3/28/2002	1537	ITMO David T. Dodge
180	3/28/2002	1538	SEC v. Leonard J. Guida and Les B. Strauss
181	4/2/2002	1539	ITMO David A. Thatcher
182	4/4/2002	1540	SEC v. Miko Leung (a/k/a Leung Ming Kang) and Sit Wa Leung
183	4/3/2002	1541	SEC v. J. Donald Nichols, Jeb L. Hughes, and C. Sheldon Whittelsey, IV
184	4/11/2002	1542	SEC v. Xerox Corporation
185	4/22/2002	1543	ITMO Teltran International Group, LTD
186	4/22/2002	1544	SEC v. Byron Robert Lerner
187	4/22/2002	1545	ITMO Michael R. Drogin, CPA
188	4/23/2002	1546	SEC v. Patrick Quinlan, Lee Wells, Keith Pietila, Alexander Ajemian, John O'Leary, Cheryl Swain and Kevin Lasky
189	4/24/2002	1547	ITMO Kenneth W. Haver, CPA
190	4/24/2002	1548	SEC v. Kenneth W. Haver
191	4/25/2002	1549	SEC v. G. Matthias Heinzelmann, III
192	4/25/2002	1550	ITMO Surety Capital Corporation
193	5/1/2002	1551	ITMO Serologicals Corporation, Inc
194	5/1/2002	1552	ITMO Michael A. Kolberg and Dale E. Huizenga
195	5/6/2002	1553	ITMO Anicom, Inc.
196	5/6/2002	1554	SEC v. Carl E. Putnam, Donald C. Welchko, John P. Figurelli, Daryl T. Spinell, Ronald M. Bandyk, and Renee L. LeVault
197	5/14/2002	1555	ITMO Edison Schools, Inc.
198	5/16/2002	1556	ITMO Dennis M. Gaito, CPA
199	5/20/2002	1557	ITMO Legato Systems, Inc. and Stephen Wise
200	5/20/2002	1558	ITMO Ernst & Young, LLP

(Continued From Previous Page)

Number	Date of release	SEC AAER number[a]	Case description
201	5/20/2002	1559	SEC v. Reza Mikailla, Gary F. Pado and Unify Corporation
202	5/20/2002	1560	SEC v. Alan K. Anderson
203	5/21/2002	1561	SEC v. David Malmstedt and Mark Huetteman
204	5/30/2002	1562	SEC v. James Murphy, et al.
205	6/5/2002	1563	ITMO Microsoft Corporation
206	6/5/2002	1564	ITMO Advanced Technical Products, Inc., James S. Carter, and Garrett L. Dominy
207	6/5/2002	1565	ITMO Katrina Krug, CPA
208	6/5/2002	1566	ITMO James E. Slayton, CPA
209	6/5/2002	1567	ITMO James E. Slayton, CPA
210	6/5/2002	1568	ITMO John K. Bradley
211	6/5/2002	1569	SEC v. John F. Mortell, Thomas F. Wraback, William S. Edwards, Gregory D. Norton, Glenn P. Duffy, Jerry W. Ross and Gerald T. Barry
212	6/6/2002	1570	SEC v. Madera International, Inc., Ramiro M. Fernandez-Moris, and Daniel S. Lezak
213	6/7/2002	1571	ITMO Korea Data Systems USA, Inc., Lap Shun (John) Hui, and Bun (Ben) Wong
214	6/7/2002	1572	ITMO Gerald S. Papazian
215	6/10/2002	1573	ITMO Ashford.Com, Inc., Kenneth E. Kurtzman, Brian E. Bergeron and Amazon.com, Inc.
216	6/10/2002	1574	SEC v. Kenneth E. Kurtzman and Brian E. Bergeron
217	6/11/2002	1575	SEC v. Aura Systems, Inc., et al.
218	6/12/2002	1576	SEC v. Patrick O. Wheeler, Steven S. Gallers, and Robert L. Carberry
219	6/14/2002	1577	SEC v. John Daws, Thomas Butler and Mark Folit
220	6/12/2002	1578	SEC v. Paul Skulsky, et al.
221	6/21/2002	1579	ITMO Rite Aid Corporation
222	6/21/2002	1580	ITMO Timothy J. Noonan
223	6/21/2002	1581	SEC v. Frank M. Bergonzi, Martin L. Grass, and Franklin C. Brown
224	6/21/2002	1582	SEC v. Bruce Hill, et al. and Richard P. Vatcher
225	6/25/2002	1583	SEC v. John N. Brincat, Sr. and Bradley Vallem
226	6/27/2002	1584	ITMO Moret Ernst & Young Accountants, n/k/a/ Ernst & Young Accountants
227	6/27/2002	1585	SEC v. WorldCom, Inc.
228	6/28/2002	1586	SEC v. WorldCom, Inc.

[a]AAERs are subsets of SEC's litigation releases and releases concerning administrative proceedings.

[b]ITMO means in the matter of.

Source: SEC (See www.sec.gov/divisions/enforce/friactions. shtml).

Frequently Cited Violations

Table 26: Accounting and Auditing Related Federal Securities Laws or Rules Violations

Federal securities laws or rules violated	Description
Section 17(a) of the Securities Act of 1933 (Securities Act)	Prohibits fraud in the offer or sale of securities.
Section 13(a) of the Securities Exchange Act (Exchange Act) and Rules 13a-1 and 13a-13 promulgated thereunder	Require issuers of registered securities to keep their registration statements accurate and file annual and quarterly reports with SEC.
Section 10(b) and Rule 10b-5 of the Exchange Act	In connection with the purchase or sale of a security, prohibit a person from making an untrue statement of a material fact or from omitting a material fact necessary to keep statements from being misleading in light of the circumstances under which they were made.
Rule 12b-20 of the Exchange Act	Requires that periodic reports contain all information necessary to ensure that statements made in such reports are not materially misleading.
Sections 13(b)(2)(A) and 13(b)(2)(B) of the Exchange Act	13(b)(2)(A) requires issuers of securities registered on an exchange to file reports to make and keep books, records, and accounts, which, in reasonable detail, accurately and fairly reflect transactions and the disposition of the issuer's assets. 13(b)(2)(B) requires such firms to devise and maintain an adequate system of internal accounting controls.
Section 13(b)(5) of the Exchange Act	Prohibits any person from knowingly circumventing or failing to implement a system of internal accounting controls or falsifying any book, record, or account, which, in reasonable detail, accurately and fairly reflects the transactions and dispositions of the assets of the issuer.
Rules 13b2-1 and 13b2-2 of the Exchange Act	13b2-1 prohibits any person from directly or indirectly falsifying a book, record, or account subject to Section 13(b)(2)(A). 13b2-2 prohibits any director or officer of an issuer from directly or indirectly making a materially false or misleading statement or from omitting to state a material fact necessary to keep statements made from being misleading, in light of the circumstances under which they were made. This rule applies to statements made (1) to accountants in connection with required audits or examinations of financial statements or (2) in the preparation or filing of documents or reports required to be filed with SEC.

Source: GAO staff analysis of SEC AAERs issued from January 2001 through February 2002.

Side-by-Side of the Existing Corporate Governance and Oversight Structure and the Sarbanes-Oxley Act of 2002

The Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley) addresses many of the concerns about the existing corporate governance and financial reporting regulatory structure by enhancing the oversight of financial accounting. One of the major cornerstones of the act is the creation of a new oversight body, the Public Company Oversight Board (Board), to oversee the audit of public companies. The act requires that any public accounting firm that performs any audit report for any publicly held company register with the Board. To ensure the independence of this new board, it will be structured as a nonprofit corporation funded by registration and annual fees from registered public accounting firms and support fees assessed to issuers. A majority of its members will be nonaccountants. Unlike the previous oversight structure [that is, now disbanded the Public Oversight Board (POB)], this new board will have sweeping powers to inspect accounting firms, set rules and standards for auditing, and impose meaningful sanctions on violators. Further, the act addresses auditor independence issues by, among other things, prohibiting auditors from providing certain nonaudit services to their audit clients and strengthening the oversight role of the board of directors.

To increase corporate accountability, corporate boards of directors' audit committee members must be "independent" and are responsible for selecting and overseeing outside auditors. In addition, pursuant to Securities and Exchange Commission (SEC or Commission) rules required by the act, top corporate officials will have to personally attest to the accuracy of their firm's accounting (and can face civil and criminal penalties if the certifications are false). The act also addresses numerous other issues aimed at strengthening investor confidence, including requiring that SEC or, at its direction, the self-regulatory organizations (SRO), implement rules addressing analysts' conflicts of interest, creating new disclosure requirements and criminal prohibitions, increasing criminal sanctions, and requiring that SEC issue rules that address standards of professional conduct for attorneys. See table 27 for an overview of key provisions of the existing structure and the new structure under Sarbanes-Oxley. This list is not intended to be an exhaustive overview of either structure.

Table 27: Side-by-Side Comparison of Existing Structure and New Sarbanes-Oxley Structure

Section	Existing (former) structure[a]	Sarbanes-Oxley
Auditing Oversight and Standards		
Federal oversight	The Securities Exchange Act of 1934 (Exchange Act) authorizes SEC to establish auditing and accounting standards. SEC has promulgated some regulations applicable to audits of public companies (SEC Rule S-X, 17 C.F.R. Part 210) but in large part delegated its authority to the American Institute of Certified Public Accountants (AICPA), which establishes and interprets generally accepted auditing standards (GAAS) through its 15 member Auditing Standards Board (ASB). ASB sets the ground rules for how an auditor determines whether the information reported in a financial statement is reasonable and whether it conforms to generally accepted accounting principles (GAAP).[b]	Establishes the Board, a private, nonprofit corporation funded by registration and annual fees from registered public accounting firms (RPAF) and support fees assessed to issuers. The act specifies that the Board is not an agency or establishment of the federal government. The Board will have five members serving full time; two members must be certified public accountants (CPA). Subject to special provisions for initial members to establish staggered terms, members will serve 5-year terms, with a lifetime limitation of two terms. Public company accounting firms must register with the Board in order to audit issuers (public companies). Subject to SEC oversight and approval of its rules, the Board has general authority to oversee the audit of public companies and protect and further the public interest in the preparation of public company audit reports. The Board is to establish rules to regulate the auditing process (auditing, quality control, ethics, independence, and other standards relating to the preparation of audit reports), conduct periodic inspections of accounting firms, investigate possible violations of auditing rules, enforce compliance with the act and, if applicable, impose sanctions (that is, for intentional, knowing, or repeated negligent violations of Sarbanes-Oxley, Board rules, securities laws and SEC rules relating to audit reports and professional standards.)

(Continued From Previous Page)

Section	Existing (former) structure[a]	Sarbanes-Oxley
Federal statutory and regulatory standards	Audit requirements are generally provided under Section 10A of the Exchange Act (15 U.S.C. 78j-1). Section 10A requires audit procedures designed to: • provide reasonable assurance of detecting illegal acts; • to identify related party transactions that are material to the financial statements; and • to evaluate whether there is substantial doubt about the continued existence as a going concern. Also under Section 10A, the auditor has a duty to investigate and take remedial measures concerning possibly unlawful acts. SEC's regulations before enactment of Sarbanes-Oxley contained an auditor independence standard and descriptions of several circumstances the Commission would consider inconsistent with the standard in determining whether an auditor was independent. These circumstances include the provision of nonaudit services during an audit and relationships between the auditor and the company. Those and other factors are "general guidance only," and their application depends on particular facts and circumstances. 17 C.F.R. § 210.2-01 (2002).	Section 10A is amended to, among other things: • limit the scope of services provided by auditors while performing an audit; • require audit committee approval of permitted nonaudit services; • require audit partner rotation every 5 years; • require reports to audit committees regarding critical accounting policies and practices, alternative treatments discussed with management, and certain written communications with management; • prohibit conflicts of interest on the part of former auditor employees who occupy certain executive positions with the public companies; and • require SEC to issue implementing rules by January 6, 2003. In addition, the Board has authority to adopt auditor independence standards.
Nongovernment organizations	AICPA is involved in the development and interpretation of auditing standards and accounting-related matters. (Until it terminated in May 2002, the Public Oversight Board, a body formed by AICPA in consultation with the SEC, oversaw AICPA members who audited SEC registrants and contributed to the development and application of auditing standards.)[c]	The Board is to cooperate on an ongoing basis with certain professional groups of accountants and advisory groups to examine the need for changes in auditing, quality control, ethics, and other standards and take other steps to increase the effectiveness of the standard setting process.
Auditing & quality control standards	ASB, a 15 member senior committee of the AICPA, promulgates GAAS, related standards governing attestation services, and quality control standards.	The Board has authority to establish standards for auditing and quality control; standards are to be set by rule and must include requirements set forth in Sarbanes-Oxley. Subject to SEC approval, the Board may adopt as rules auditing standards proposed by one or more professional groups of accountants or advisory groups.

(Continued From Previous Page)

Section	Existing (former) structure[a]	Sarbanes-Oxley
Auditor independence	The AICPA Code of Professional Conduct contains auditor independence rules that address many of the same matters addressed by SEC auditor independence rules for auditors of SEC registrants (SEC regulation S-X). On July 31, 2002, AICPA published its "Plain English Guide to Independence" to assist accountants in understanding independence requirements. SROs listing rules [New York Stock Exchange (NYSE), National Association of Securities Dealers (NASD), American Stock Exchange (Amex)], with amendments submitted to SEC in August 2002 for approval, establish requirements for corporate audit committee independence from and control over auditors and the oversight and approval of nonaudit services.	As discussed above, SEC is to promulgate rules implementing Sarbanes-Oxley auditor independence standards by January 6, 2003. The Board has authority to issue rules establishing auditor independence and any other appropriate independence standards.
Ethics	Professional Ethics Executive Committee (PEEC)—AICPA's Ethics Division (16 members from private practice and 5 members from academia and the legal profession) is responsible for maintaining, interpreting and enforcing the AICPA Code of Professional Conduct and, when appropriate, suggesting changes to the Code. The division investigates any allegation of wrongdoing by members made by the public, federal or state regulatory bodies, other AICPA or other appropriate sources. The division also initiates investigations if it becomes aware of allegations of wrongdoing through media reports or federal or state regulatory action. The division is responsible for AICPA's auditor independence rules.	General rulemaking authority to establish ethics requirements.
Oversight of Organizations Responsible for Auditor Regulation and Auditing Standards		
Oversight	SEC has no authority over the composition, funding, activities, or subsidiaries of the AICPA. SEC has accepted GAAS promulgated by the ASB as the standards for audits.	SEC has general oversight authority over the Board. SEC responsibilities include: • planning and approving capability and capacity of the Board; • oversight and enforcement authority over the Board; • approval of Board rules; • removal of Board member(s) for good cause; and • review of Board inspection findings and challenges to draft findings (this authority also is provided to appropriate state regulators).

(Continued From Previous Page)

Section	Existing (former) structure[a]	Sarbanes-Oxley
Communications with audit committee	AICPA audit and attest standards require, among other things, communications with audit committee about the auditor's judgments on the quality of the company's accounting principles and communications with management. (See, for example, AIPCA Audit and Attest Standards, Statements on Audit Standards Nos. 61, 71). SRO corporate governance rules, as proposed to SEC in August 2002, contain similar audit committee requirements.	RPAF must report to audit committee on critical accounting policies and practices to be used, treatments of financial information within GAAP discussed with issuer's management and related matters, and material written communications between RPAF and issuer's management.
Corporate Governance		
Audit committee compliance	SEC Rules require proxy disclosure of audit committee members' independence. SRO rules require audit committee charters to cover audit committee financial expertise and oversight of independent auditors. NYSE, NASD, Amex have submitted to SEC for approval proposed amendments to corporate governance listing standards, which include audit committee independence standards and audit oversight requirements.	Not later than 270 days after enactment of Sarbanes-Oxley, SEC must promulgate rules directing national securities exchanges and national securities associations to prohibit the listing of any security of any issuer that is not in compliance with Sarbanes-Oxley provisions requiring audit committee responsibility for oversight of RPFA, audit committee independence, audit committee complaint processing procedures, and funding for RPAFs and audit committee advisers.
Audit committee responsibilities	Audit committee responsibilities, which include audit committee independence standards and audit oversight requirements, are contained in SRO listing requirements and in fiduciary and other duties based on state laws. Guidance on auditor relationship with audit committee is set forth in AICPA Statements on Accounting Standards.	The audit committee is responsible for appointment, compensation, and oversight of RPAF employed by issuer; Each audit committee member must be a member of issuer's board of directors and be otherwise independent; Audit committee must establish procedures for receipt, retention, and treatment of complaints received by the issuer regarding accounting, internal accounting controls, auditing matters and the confidential, anonymous treatment of submissions by employees concerning questionable accounting or auditing matters. Auditing and permissible nonaudit services must be preapproved by the issuer's audit committee.

(Continued From Previous Page)

Section	Existing (former) structure[a]	Sarbanes-Oxley
Executive officers & directors, report certification	There are no statutory requirements that the chief executive officer or the chief financial officer (CFO) certify certain (CEO) periodic corporate financial statements. Under instructions issued by SEC for periodic and other filings, there was a general requirement that the forms had to be signed by officers, and in the case of annual reports, by a majority of the directors as well. These signing requirements did not include any type of certification or other attestation regarding the accuracy or completeness of the report. On June 14, 2002, SEC published a Notice of Proposed Rulemaking, containing a requirement that a company's CEO and CFO certify that the information contained in its financial reports is complete and true in all-important respects. On June 27, 2002, SEC issued an order requiring the CEOs of 945 companies (each with reported annual revenues in excess of $1.2 billion) personally to make a one-time written certification, under oath, that their company's most recent periodic reports filed with the Commission are complete and accurate.	Principal executive officer(s) and principal financial officer(s) must certify the following in each annual or quarterly report: • signing officer has reviewed the report; • the report fairly presents, in all material respects, issuer's operations and financial condition; SEC issued final rules requiring the certification effective August 29, 2002 (See the later description in this table of a corresponding criminal provision relating to director and officer certifications).
Executive officers & directors, improper influence	Under state law fiduciary principles and applicable federal securities laws, officers, directors could be liable to the company and/or shareholder for causing materially false corporate financial reports.	Subject to SEC rules, officers and directors, and those acting at their direction, are prohibited from fraudulently influencing or misleading any independent public or certified accountant conducting audit for the purpose of making financial statements materially misleading.
Executive officers & directors, forfeiture for restatement resulting from misconduct		Issuer CEOs and CFOs must reimburse issuer for bonuses, incentive-based or equity-based compensation, and profits from sales of issuer securities received during 1-year period following an accounting restatement due to material noncompliance with financial reporting requirements resulting from misconduct.
Executive officers & directors, pension fund blackout		Directors and executive officers of issuers are prohibited from selling, purchasing, or transferring stock during pension fund blackout periods (that is, when at least 50 percent of beneficiaries are prohibited from trading); blackout period requires 30-day prior notice; profits from such insider trades are to be recovered by issuer.
Executive officers & directors, personal loans prohibited	In most states, a corporation may lend money to an officer or director if the board of directors authorizes the loan and finds that it will "benefit" the corporation.	Issuers are prohibited from making personal loans (with some exceptions) to or for any director or executive officer.

(Continued From Previous Page)

Section	Existing (former) structure[a]	Sarbanes-Oxley
Corporate Disclosure		
Disclosure of approval of non-audit services	SEC regulations require disclosure in proxy statements of fees paid for services rendered by the company's principal accountant. 17 C.F.R. § 14a-101, Instruction Item 9 (2002).	Issuer must disclose in periodic reports the audit committee's approval of a nonaudit service to be performed by the issuer's auditor.
Director, officer and principal stockholder disclosure regarding holdings of issuer securities	Section 16(a) of the 1934 Act requires certain insiders (directors, officers, beneficial owners of more than 10 percent equity) to file a Section 16(a) transaction report (reporting any change in the person's ownership of, or any purchase or sale of, a security-based swap agreement involving the company's equity security). Previously, this reporting was required within 10 days after the close of the calendar month in which the transaction occurred.	Section 403 of the act amends section 16(a) of the Exchange Act to shorten the due date for Section 16 insiders (directors, officers, and beneficial equity owners of more than 10 percent of a company's equity) to file Section 16(a) transaction report. These transaction reports must be filed within 2 business days after the transaction has been executed. SEC may, by rule, provide for later than 2-day reporting should the agency determine cases in which the 2-day period is not feasible. Beginning not later than one year after the enactment of the act, these ownership and trading reports will be required to be filed electronically and made rapidly available on the internet. On August 28, 2002, SEC adopted final implementing rules, which became effective August 29, 2002.[d]
Off-balance-sheet transactions	In its "Commission Statement About Management's Discussion and Analysis of Financial Condition and Results of Operations," SEC. Rel. Nos. 33-8056; 34-45321 (Jan. 23, 2002), SEC discussed circumstances under which the "Management's Discussion and Analysis" portion of a financial statement (MD&A) required by Regulation S-K, 17 C.F.R. § 229.303, should include a discussion of the company's off-balance-sheet transactions and relationships. The rule did not specifically require such a discussion. For SPE partnerships, consolidation was not required if, among other things, an independent third party invested at least 3 percent of the capital. The Financial Accounting Standards Board is proposing to raise this threshold and change other conditions for avoiding consolidation on the sponsor's balance sheet.	Subject to mandated SEC rules, issuers must disclose material off-balance-sheet transactions and relationships that may have a material effect on the issuer's financial condition and present pro forma financial information in a manner that is not misleading and, under GAAP, is reconcilable with the issuer's financial condition.
Internal control report		Subject to mandated SEC rules, annual reports must contain an "internal control report" describing management responsibility for, and effectiveness of, internal controls for financial reporting; RPAF that prepares or issues the issuer's audit report must attest to and report on management's assessment.

(Continued From Previous Page)

Section	Existing (former) structure[a]	Sarbanes-Oxley
Financial officer code of ethics		SEC rules for periodic reports must require an issuer to disclose whether it has adopted a code of ethics for senior financial officers or explain why a code has not been adopted, and rules for updated disclosure (Form 8-K) must require issuer immediately to disclose any change in or waiver of the code of ethics for senior financial officers.
Audit committee financial expertise	Prior to Sarbanes-Oxley, SRO rules required all audit committee members to satisfy financial literacy requirements and to have at least one member with financial management expertise.	Subject to SEC rules, the issuer must disclose, together with periodic reports, whether its members include at least one financial expert or explain why at least one member of the committee is not a financial expert, as that term is defined by SEC.
Material changes of financial condition or operations	SEC Form 8-K must be filed with SEC within certain time periods after the occurrence of an event listed on the form. These events relate to the company's financial condition or operations. The periods range from 5 business days to 15 calendar days. SEC has issued proposed rules setting forth additional events to be reported. SEC Rel. Nos. 33-8106; 34-46084 (June 17, 2002). The Commission proposed to accelerate the Form 8-K filing deadline by requiring companies to file the form within 2 business days after the occurrence of a triggering event.	In connection with registration statements and periodic reports, a public company must publicly disclose "on a rapid and current basis" such information concerning material changes in the issuer's financial condition or operations, as is to be required by SEC rule.

(Continued From Previous Page)

Section	Existing (former) structure[a]	Sarbanes-Oxley
Fraud Accountability (Title VIII of Sarbanes-Oxley)		
Destruction, alteration, falsification of records in federal investigations and bankruptcy	Prior to the Sarbanes-Oxley, anyone who "corruptly persuades" others to destroy, alter or conceal evidence can be prosecuted under 18 U.S.C. § 1512. Section 1512 reaches destruction of evidence with intent to obstruct an official proceeding that may not yet have been commenced. However, Section 1512 does not reach the "individual shredder." While prosecution of obstruction under 18 U.S.C. § 1505 does not require "corrupt persuasion," it does require the existence of a pending proceeding. In addition, existing law does not explicitly address the retention of accounting work papers for a fixed period of time.	Prohibits knowingly destroying, altering, concealing or falsifying records with the intent to obstruct or influence an investigation in a matter within the jurisdiction of any U.S. department or agency or any bankruptcy case; imposes penalty of a fine or not more than 20 years in prison or both. Section 802 adds two new criminal provisions, 18 U.S.C. §§ 1519 and 1520. Section 1519 expands existing law to cover the alteration, destruction or falsification of records, documents or tangible objects, by any person, with intent to impede, obstruct or influence, the investigation or proper administration of any "matters" within the jurisdiction of any department or agency of the United States, or any bankruptcy proceeding, or in relation to or contemplation of any such matter or proceeding. This section explicitly reaches activities by an individual "in relation to or contemplation of" any matters. No corrupt persuasion is required. New Section 1519 should be read in conjunction with the amendment to 18 U.S.C. 1512, added by Section 1102 of Sarbanes-Oxley, discussed below, which similarly bars corrupt acts to destroy, alter, mutilate or conceal evidence, in contemplation of an "official proceeding."
Destruction of corporate audit records	Prior to enactment of Sarbanes-Oxley, there was no general legal duty that an accountant maintain client files for a particular time interval. Accountants are subject to various documents retention requirements depending upon the subject matter. For example, some federal regulations contain document retention requirements, and some state insurance laws require the retention of insurance company audit documents for specific time periods. See Office of the Federal Register, *Guide to Record Retention Requirements in the Code of Federal Regulations,* published with annual supplements; see also, Skupsky, ed., *Legal Requirements for Business Records: Federal and State,* a four-volume loose leaf; and Hancock, ed., *Guide to Records Retention (1986). Some states*—Colorado, Georgia, Illinois, Maryland, New Hampshire, North Dakota, Oklahoma and Texas—have adopted the Uniform Preservation of Private Business Records Act or its equivalent, which contains a 3 year retention requirement that may be applicable to audit records. See http://www.accountantslaw.com/documentretentionpolicies.htm	Mandates that any accountant who conducts an audit of a public corporation shall maintain all work papers for 5 years and instructs SEC to promulgate rules regarding record retention; knowing and willful violation of the 5 year retention requirement and/or SEC retention rules is punishable by a fine or 10 years in prison or both. Accountants who fail to retain the audit or review workpapers of a covered audit for a period of 5 years will violate Section 1520, which creates a new felony, with a maximum period of incarceration of 10 years. Under rulemaking authority granted in Section 1520(b), SEC will promulgate rules relating to the retention of workpapers and other audit or review documents.

(Continued From Previous Page)

Section	Existing (former) structure[a]	Sarbanes-Oxley
Nondischarge provision	Section 523 of the federal bankruptcy code, 11 U.S.C § 523, contains a list of exceptions to provisions of the code permitting the discharge of debts.	The act amends federal bankruptcy law so that a debtor cannot discharge in bankruptcy any order or settlement arising from a claim that the debtor has violated any Federal or state securities law or regulation, or from a claim of common law fraud, deceit, or manipulation in connection with the purchase or sale of any security. Debts for penalties, fines, damages, disgorgement payments and other costs and payments, likewise, may not be discharged in bankruptcy.
Statute of limitations for private right of action based on contravention of securities regulations	Previous law allowed for a suit to be brought within 1 year after discovery of violation or 3 years after occurrence of violation.	Section 804 establishes a statute of limitations for claims of fraud, deceit, manipulation, or contrivance in contravention of a regulatory requirement concerning federal securities laws as follows: • 2 years after discovery of facts constituting the violation; • 5 years after such violation.
Sentencing commission review	Under previous law, questions arose about whether the Sentencing Guidelines sufficiently address obstruction of justice crimes.	Section 805 requires the U.S. Sentencing Commission to undertake an expedited review of these issues, particularly in light of the two new obstruction of justice statutes, described above. It also directs the Sentencing Commission to consider a number of factors such as destruction of a large amount of evidence, participation of a large number of individuals, or destruction of particularly probative or essential evidence, which might be considered sufficiently aggravating as to warrant additional enhancements or inclusion as offense characteristics.
Whistle-blower protection		Section 806 prohibits public companies, their officers, employees, contractors and agents from retaliatory actions against employees who assist in proceedings involving alleged securities violations and provides an administrative process for employees seeking relief for violators. Also, the section provides for a civil action based on a violation of the section.
Criminal penalties for securities fraud	The previous federal criminal laws (Title 18 of the U.S. Code) did not have a specific crime directly prohibiting securities fraud schemes. Prosecutors have found it necessary to reach many securities fraud schemes through the mail and wire fraud statutes. Securities fraud has also been prosecuted as a violation of provisions of the federal securities laws.	Section 807 of Sarbanes-Oxley creates a specific felony for securities fraud punishable by fine or up to 25 years incarceration. This provision complements existing securities law. The statute requires a nexus to certain types of securities, but no proof of the use of the mails or wires is required.

(Continued From Previous Page)

Section	Existing (former) structure[a]	Sarbanes-Oxley
Evidence tampering & impeding official proceedings	Title 18 U.S.C. § 1512, in part, provides a 10 year maximum term of incarceration for an offender who corruptly persuades another person with the intent to, in part, destroy or alter evidence.	Section 1102 of Sarbanes-Oxley imposes a fine and/or a term of imprisonment of up to 20 years on any person who corruptly alters, destroys, mutilates or conceals a record, document, or other object with the intent to impair the object's integrity or availability for use in an official proceeding, or who corruptly otherwise obstructs, influences or impedes an official proceeding. (The Attorney General advises that Section 1512, as amended, should be read in conjunction with the new Section 1519, added by section 802 of this act, which criminalizes certain acts intended to impede, obstruct, or influence "any matter" within the jurisdiction of any department or agency of the United States, or in relation to or contemplation of any such matter. The term "corruptly" shall be construed as requiring proof of a criminal state of mind on the part of the defendant. See Field Guidance on New Criminal Authorities Enacted in the Sarbanes-Oxley Act of 2002 (H.R. 3763) Concerning Corporate Fraud and accountability http://www.usdoj.gov/ag/readingroom/sarox1.htm)
Freeze on extraordinary payments		Section 1103 of Sarbanes-Oxley authorizes SEC to petition courts for a temporary escrow of extraordinary payments that might by made to any director, officer, employee, partner, controlling person or agent during the course of an investigation involving potential violations of the federal securities laws.
Sentencing guidelines	Questions have arisen whether the current Sentencing Guidelines sufficiently address securities, accounting, and pension fraud, and related offenses.	Section 1104 of Sarbanes-Oxley requests the Sentencing Commission to study existing guidelines and consider expedited issuance of amended guidelines, within 180 days after enactment of Sarbanes-Oxley, which address securities, accounting, and pension fraud, and related offenses.
Officer & director prohibition	Under current law, a court may bar an officer or director from serving as an officer or director of a public company if SEC proves that the conduct of that person demonstrates “substantial unfitness” to serve in that capacity.	Section 1105 authorizes SEC, in administrative Cease and Desist (C&D) proceedings, to prohibit any person who has violated the antifraud provisions of the Exchange Act or the Securities Act of 1933, or SEC’s rules under those provisions, from acting as an officer or director of any public company if the conduct demonstrates unfitness to serves as an officer or director. Sarbanes-Oxley eliminates the word "substantial," thereby permitting a bar based on the person's unfitness. In addition, the act empowers SEC to prohibit any person who violates Federal securities laws, rules, or regulations from acting as an officer or director of any public company if the person is unfit to serve in such a capacity.
Increased criminal penalties for Exchange Act violations	Section 32(a) of the Exchange Act, 15 U.S.C. § 78ff, provides for a criminal fine of $1 million for individuals and/or imprisonment of up to 10 years, or a fine of $2.5 million for anyone other than an individual.	Section 1106 increases penalties under the Exchange Act to $5 million or imprisonment of not more than 20 years and increases the fine to $25 million for persons other than a natural person.

(Continued From Previous Page)

Section	Existing (former) structure[a]	Sarbanes-Oxley
Penalties for retaliation	There is no explicit protection from retaliation for an individual who provides truthful information to a law enforcement officer concerning the commission or possible commission of a federal offense.	Section 1107 provides for a new subsection (e) of 18 U.S.C. § 1513, which creates a felony offense for any person knowingly to take any action, with intent to retaliate, harmful to a person who provides such information concerning a federal offense. An offense is subject to a fine or imprisonment of not more than 10 years or both.
White-Collar Crime		
Increased criminal penalties	Under previous law (Chapter 63 of U.S. Code Title 18—Mail Fraud) conspiracies to violate the mail fraud statute (§ 1341), the wire fraud statute (§ 1343), the bank fraud statute (§ 1344) and the health care fraud statute (§ 1347) are punishable by a maximum 5 year sentence. The wire fraud offense did not explicitly reach "attempts" to commit the substantive offense. However, this was not an impediment in practice, because proof of a scheme to defraud did not necessarily require proof that the scheme was successful.	Section 902 of Sarbanes-Oxely amends 18 U.S.C. § 1349 to provide that attempts and conspiracies to commit the substantive federal fraud offenses described in the adjacent column, as well as the new securities fraud offense, will have the same maximum punishment as the substantive crime. This section also effectively adds an “attempt” to commit the wire fraud offense (18 U.S.C. § 1343) as a federal crime. The remainder of the fraud statutes already includes “attempts.”
	Under previous law, the maximum term of imprisonment for violations of the mail and wire fraud statutes (18 U.S.C. §§ 1341, 1343) is 5 years, with the exception of fraud affecting a financial institution, which has a maximum term of incarceration of up to 30 years.	Section 903 of Sarbanes-Oxley amends 18 U.S.C. §§ 1341 and 1343 by increasing the maximum 5-year penalty for mail or wire fraud to 20 years. The maximum term of incarceration for fraud affecting a financial institution remains at a maximum of 30 years.
	Under the previous provision of ERISA, 29 U.S.C. § 1131, any person who willfully violates the reporting and disclosure requirements concerning employee benefit plans as set forth in 29 U.S.C. §§ 1021-1031, or any regulation or order issued thereunder, is punishable by a fine, and/or a term of imprisonment not to exceed 1 year.	Section 904 of Sarbanes-Oxley increases the fines in 29 U.S.C. § 1131 to $100,000 (for an individual person), $500,000 (for persons other than an individual). Section 1131 also increases the maximum term of imprisonment from 1 year (a misdemeanor) to a maximum term of imprisonment of 10 years. The increase in the fine for individuals will have no limiting effect insofar as individuals convicted of violating Section 1131 will now be subject to the alternative fine provisions of 18 U.S.C. § 3571 for felony convictions. In the absence of restrictive language in Section 904 of the Act, individuals will be subject to the maximum fine of $250,000, or fine based on the defendant's gain or the victims’ loss, under § 3571. While the amendment also increases the fine in § 1131 to $500,000 for persons other than an individual, this change has merely increased the fine to the level of the maximum fine for an organization already set forth in § 3571.

(Continued From Previous Page)

Section	Existing (former) structure[a]	Sarbanes-Oxley
Sentencing commission	Under previous law, questions have arisen whether the Sentencing Guidelines sufficiently address white-collar offenses.	Section 905 of Sarbanes-Oxley reaches beyond Section 803 of the act, described above, which addresses sentencing guidelines solely for obstruction of justice. Section 905 requires that the Sentencing Commission study the existing guidelines and consider expedited issuance of amended guidelines within 180 days after enactment of this Act, which would address all the new criminal provisions and increased criminal penalties in Sarbanes-Oxley. This section also requires the Sentencing Commission to consider the broader issues of whether the white-collar crime guidelines provide for sufficient deterrence and punishment, and assure reasonable consistency with other relevant directives and guidelines.
Certification of financial reports and criminal penalties for knowingly false certification	As discussed previously, there are no statutory requirements that the chief executive officer or the chief financial officer certify certain periodic corporate financial statements.	Section 906 of Sarbanes-Oxely enacts new 18 U.S.C. § 1350, which requires that the chief executive officer and the chief financial officer (or the equivalent thereof) of a public company provide a statement certifying that the periodic reports containing financial statements filed with SEC fully comply with the requirements of Sections 13(a) and 15(d) of the Exchange Act, and that the information contained in the periodic reports fairly presents, in all material respects, the financial condition and results of operations of the issuer. Certifying a report while knowing that it does not comport with all of the requirements of § 1350 is punishable by a fine of not more than $1 million and imprisonment of up to 10 years. A willful violation is punishable by a fine of not more than $5 million and imprisonment of up to 20 years.

(Continued From Previous Page)

Section	Existing (former) structure[a]	Sarbanes-Oxley
Analyst Conflict of Interest		
Analyst independence rules	NASD Rule 2711 and NYSE Rule 472 establish standards for communications with the public to address research analyst conflicts of interest. (See pp. 65 to 66).	Requires SEC or, as directed by SEC, a registered SRO, to adopt rules to address conflicts of interest that can arise when securities analysts recommend equity securities in research reports and public appearances, including rules: • restricting the prepublication clearance or approval of research reports by persons either engaged in investment banking activities or not directly responsible for investment research; • limiting the supervision and compensatory evaluation of securities analysts to officials who are not engaged in investment banking activities; • prohibiting a broker or dealer involved with investment banking activities from retaliating against a securities analyst as a result of an unfavorable research report; • establishing periods during which brokers or dealers who served as underwriters or dealers in a public offering should not publish or otherwise distribute research reports relating to the pertinent securities or their issuer; • establishing safeguards to ensure that securities analysts are separated within the investment firm from the review, pressure, or oversight of those whose involvement in investment banking might potentially bias the analyst's judgment or supervision (§ 501(a)). SEC has issued for comment proposed regulation AC, which would require research analysts to certify that the views expressed by the analyst in a research report or public appearance accurately reflect the analyst's personal views and whether the analyst received compensation in connection with his or her specific views and recommendations. SEC Rel. Nos. 33-8119; 34-46301 (Aug. 2, 2002).
Conflict of interest disclosure rules	See independence rule. Voluntary disclosure by firms. SEC's August 2, 2002, proposed regulation would require that any research report accurately reflect the analyst's personal views, and whether the analyst received compensation or other payments in connection with his or her specific recommendations or views.	Requires SEC or, as directed by SEC, a registered SRO to adopt rules requiring securities analysts (in public appearances) and broker/dealers in research reports) to disclose specified conflicts of interest that are known or should have been known at the time of the appearance or the date of distribution of the report.

(Continued From Previous Page)

Section	Existing (former) structure[a]	Sarbanes-Oxley
Other SEC-Related Provisions		
Professional conduct standards	No explicit rules of conduct for attorneys.	SEC must issue rules establishing minimum standards of professional conduct for attorneys appearing and practicing before SEC that require, among other things: • Reporting issuer's CEO or general counsel evidence of material violation of securities law, breach of fiduciary duty or similar violation by issuer or issuer's agent; • Report the evidence to issuer's audit committee or another committee outside directors or the entire board if general counsel or officer fail to respond appropriately (§ 307).
SEC resources & authority	SEC's 2002 budget appropriation was $437.9 million and the 2003 President's budget request included a budget estimate of $466.9 million for SEC. In addition to various other authorities, SEC has authority to establish auditing and accounting standards	Section 601 authorizes fiscal year 2003 budget of $776 million to carry out activities described in the section.
Censure & denial of appearance before SEC	SEC, under its Rule of Practice 102(e), could censure or deny appearance before SEC by any person, including a licensed professional who lacks character or integrity, engaged in unethical or improper professional conduct, or willfully violated or willfully aided and abetted the violation of the federal securities laws or the rules and regulations issued thereunder.	Codifies SEC authority to censure any person or deny any person the privilege to practice before the Commission if SEC appropriately determines that the person lacks requisite qualifications, lacks character or integrity, engaged in unethical or improper professional conduct, or willfully violated or willfully aided and abetted the violation of the federal securities laws or the rules and regulations issued thereunder.
Penny stock bars		In SEC injunctive proceedings against persons involved in penny stock offerings, the court may prohibit the person from participating in penny stock offerings (§ 603).
Associated persons of broker/dealers		A broker/dealer may be subject to registration sanctions if: • an associated person of the broker/dealer is subject to an SEC order barring or suspending the right of the person to be associated with a broker or dealer; • an associated person is subject to final order of a state financial regulator, a federal banking agency or the National Credit Union Administration barring the person from association with a regulated entity or is based on violations of laws or regulations prohibiting fraudulent, manipulative or deceptive conduct.

[a]Although SEC has had authority to establish and enforce auditing and accounting standards, it has relied upon self-regulatory bodies—the AICPA and Financial Accounting Standards Board (FASB)—to establish such standards. Sarbanes-Oxley focuses primarily on auditing standards and practices by placing fundamental functions and responsibilities of auditing oversight and standards with the Board. Section 108(b) of Sarbanes-Oxley does, however, amend the Exchange Act to provide that that SEC may recognize accounting principles as "generally accepted" if those principles are established by a private standard-setting body described in section 108(b). This table focuses on the audit-related provisions of Sarbanes-Oxley.

[b]Accounting standards (GAAP) are set primarily by the FASB. Other sources of GAAP include FASB task forces and AICPA staff.

[c]In a recent speech, the AICPA's President and chief executive officer (CEO) described the AICPA's role in light of the Sarbanes-Oxley Act. According to the speech, AICPA will continue to serve as a

means for CPAs to establish their own professional standards; function as a liaison between market institutions and corporations to help protect investors; perform research, educational and training functions; seek improvements in financial reporting; and promote strong corporate governance and internal control systems. A New Accounting Culture: Address by Barry C. Melancon, September 4, 2002, Yale Club - New York City, http://www.aicpa.org/news/2002/p020904a.htm.

[d]SEC Rel. Nos. 34-46421; 35-27563; IC-25720 (August 28, 2002). Under the rules, reporting persons must report transactions in the securities of their companies within two business days of the transaction, i.e., before the end of the second business day following the day on which the transaction is executed. There are two narrow exceptions to the rule. They define the date of execution differently with respect to two specific types of transactions in which the reporting person neither controls and nor selects the date of execution and may not know about it until he or she is timely notified.

Source: GAO legal analysis.

GAO Contacts and Staff Acknowledgments

GAO Contacts

Davi M. D'Agostino (202) 512-8678
Orice M. Williams (202) 512-8678

Acknowledgments

In addition to those individuals named above, Kevin Averyt, Matthew Bridges, M'Baye Diagne, Heather Dignan, Lawrance Evans, Jr., Benjamin Federlein, Joe Hunter, Edwin Lane, May Lee, Mitchell Rachlis, LaSonya Roberts, Barbara Roesmann, Nicholas Satriano, Paul Thompson, and Richard Vagnoni made key contributions to this report.

Glossary

Term	Definition
Asset write-down/write off	To charge an asset amount to an expense or loss in order to reduce the value of the asset and therefore, earnings. Occurs when an asset was initially overvalued or loses value.
Commercial paper	Consists of short-term (up to 270 days), unsecured promissory notes issued by corporations to raise cash for current transactions, typically for financing accounts receivable and inventories. Many companies find commercial paper to be a lower-cost alternative to bank loans.
Derivative	A security whose value depends on the performance of an underlying, previously issued securities. Used properly these instruments can be useful in reducing financial risk. Examples include, options, swaps, and warrants.
Goodwill	The excess of the purchase price over the fair market value of an asset. Goodwill arises when the price paid for a company exceeds that suggested by the value of its assets and liabilities.
Impairment	Generally refers to a reduction in a companies stated capital, however impairment can be used in any context such as "asset impairment" or "goodwill impairment." Impairment is usually the result of poorly estimated gains or losses.
Option	Contracts that gives the holder the option, or right, to buy or sell the underlying financial security at a specified price, called the strike or exercise price during a certain period of time or on a specific date. Options on individual stocks are called stock options.
Round-trip transactions	A method used to inflate transaction volumes or revenue through the simultaneous purchase and sale of products between colluding (related-party) companies.

Special purpose entity (SPE)	Also known as a "Special Purpose Vehicle." A business interest formed solely in order to accomplish some specific task or tasks. A business may utilize a special purpose entity for accounting purposes, but these transactions must still adhere to certain regulations. Used properly these subsidiary companies are used to isolate financial risk. Their asset/liability and legal status make its obligations secure even if the parent company goes bankrupt. Used improperly SPEs can serve to inflate revenue, hide debt or understate risk exposure. Enron used accounting loopholes to use SPEs improperly.
Warrant	A security that gives the holder certain rights under certain conditions both determined by the issuer of the warrant. For example, an exchange privilege may allow the holders to exchange 1 warrant plus $5 in cash for 100 shares of common stock in the corporation, any time after some fixed date and before some other designated date.

GAO's Mission

The General Accounting Office, the investigative arm of Congress, exists to support Congress in meeting its constitutional responsibilities and to help improve the performance and accountability of the federal government for the American people. GAO examines the use of public funds; evaluates federal programs and policies; and provides analyses, recommendations, and other assistance to help Congress make informed oversight, policy, and funding decisions. GAO's commitment to good government is reflected in its core values of accountability, integrity, and reliability.

Obtaining Copies of GAO Reports and Testimony

The fastest and easiest way to obtain copies of GAO documents at no cost is through the Internet. GAO's Web site (www.gao.gov) contains abstracts and full-text files of current reports and testimony and an expanding archive of older products. The Web site features a search engine to help you locate documents using key words and phrases. You can print these documents in their entirety, including charts and other graphics.

Each day, GAO issues a list of newly released reports, testimony, and correspondence. GAO posts this list, known as "Today's Reports," on its Web site daily. The list contains links to the full-text document files. To have GAO e-mail this list to you every afternoon, go to www.gao.gov and select "Subscribe to daily E-mail alert for newly released products" under the GAO Reports heading.

Order by Mail or Phone

The first copy of each printed report is free. Additional copies are $2 each. A check or money order should be made out to the Superintendent of Documents. GAO also accepts VISA and Mastercard. Orders for 100 or more copies mailed to a single address are discounted 25 percent. Orders should be sent to:

U.S. General Accounting Office
441 G Street NW, Room LM
Washington, D.C. 20548

To order by Phone: Voice: (202) 512-6000
TDD: (202) 512-2537
Fax: (202) 512-6061

To Report Fraud, Waste, and Abuse in Federal Programs

Contact:

Web site: www.gao.gov/fraudnet/fraudnet.htm
E-mail: fraudnet@gao.gov
Automated answering system: (800) 424-5454 or (202) 512-7470

Public Affairs

Jeff Nelligan, managing director, NelliganJ@gao.gov (202) 512-4800
U.S. General Accounting Office, 441 G Street NW, Room 7149
Washington, D.C. 20548

PRINTED ON RECYCLED PAPER