Financial Restatements: Potential Causes and Severe Ramifications

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Though the number of financial restatements has decreased somewhat since 2007, the overall number has risen dramatically over the past decade. Passage of the Sarbanes-Oxley Act in 2002 significantly increased the severity of rules and regulations related to corporate governance and accounting, which in turn has led to a marked increase in the number of restatements. These restatements can thus be largely attributed to a significant number of errors and misapplications of Generally Accepted Accounting Principles (GAAP).

What are Financial Restatements?

Restatements must be submitted when, for a variety of possible reasons, previously released financial information has been deemed inaccurate. Restatements could become necessary due to mundane clerical errors, inaccurate treatment of government regulations, or even fraud.

Financial restatements, despite the cause, are considered major corporate reporting errors. They undermine the reputation of not only those individuals—such as accountants, managers and members of the Board of Directors—who are directly responsible for reporting financial information, but also of the company as a whole.

Such mistakes can threaten the future success of the company. In fact, studies have shown that restatement announcements affect not only stock prices, but also raise serious questions about a company's accounting practices and shake investor confidence. Notably, in the wake of the Enron scandal, the USB/Gallup Index of Investor Optimism reported that 84 percent of those polled said "questionable accounting practices" had a significant impact on their willingness to invest funds. Restatements are considered by many to be a sign of such unreliability.

Financial restatements also place significant pressure on accounting departments. Besides shining doubt on their activities, restatements also strain general departmental operations. After a restatement, there is greater pressure to ensure complete accuracy. Accounting departments—as well as any associated managerial heads—are often placed under increased scrutiny.

Causes of Restatements

Restatements may be necessary for a variety of reasons. While in some cases, financial restatements may be caused by criminal activities such as corporate fraud, most commonly restatements are simply triggered by incorrect revenue recognition or other misapplication of GAAP.

GAAP is exceptionally complex and has become more so over the past few years as standards have evolved both domestically and overseas. There are now hundreds of rules and regulations governing accounting practices, which have been laid out by both the FASB and the IASB. In particular, certain changes in GAAP may apply retroactively, thereby affecting the prior year's financial statements. In such cases, comparison statements need to be restated to accommodate the revised policies. This heightened complexity, in combination with increasingly strict regulations laid out by the Sarbanes-Oxley Act of 2002,

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has led to a surge in restatements. In fact, a Securities and Exchange Commission (SEC) study conducted in April 2011 found that 80 percent of all restatements that occurred in 2009 were the result of misapplied GAAP.

While such regulatory and governmental causes cannot be avoided, there are other potential grounds for restatement that may be avoided. For example, a lack of operational transparency can sometimes lead to a need for financial restatements. In such instances, a restatement can easily be averted by assessing transparency levels, and adjusting them accordingly. Greater oversight can also ensure that restatements due to misclassification are unnecessary. Misclassification refers specifically to incidences in which balance sheet accounts are classified incorrectly, as well as the improper classification of income or statements of cash flow items. Most commonly, errors are made in the reporting of cash flow. While this is a common clerical error, such mistakes also are a warning signal to investors, as cash flow statements are typically used to assess a company's earnings. Errors in this arena could frighten off potential investors or raise suspicions among current shareholders.

In Summary

Restatements have risen significantly in the last decade. While restatements may be caused by a number of factors, including fraud, most commonly restatements at present are the result of accounting errors and the misapplication of GAAP. Most notably:

- The Sarbanes-Oxley Act of 2002 laid out a series of stringent rules and regulations that have, in combination with the increasingly complex GAAP, resulted in a greater number of restatements.
- Private companies typically submit a far smaller proportion of restatements than public companies.
- Restatements can have widespread effects which, while dependent on the specific cause of the restatement, can include negative market reactions, increased pressure on management and accounting operations, and even diminished investor confidence.

Restatements can cause significant harm to your company's reputation. If you do not feel that your accounting department is equipped to accurately manage changing GAAP, or if you are faced with having to submit a restatement, it can be helpful to consider outside assistance. A CFO services firm can provide expert advice on navigating difficult GAAP terrain, and can advise on a way to handle a restatement that will cause the least damage to your company's future success.

References and Further Reading

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