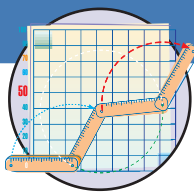

Standards IN PRACTICE

PROFESSIONAL PRACTICE

The State of Restatements

A study of financial restatements yields surprising findings

BY LORI PIZZANI

The causes of financial restatements are many—human error, honest accounting misapplications, aggressive accounting techniques, or just plain fraud. Add in regulatory changes, accounting changes, and periodic scandals, and investors can be sure that restatements are here to stay.

Less clear is what level of restatements should be considered normal. In 1997, U.S. companies filed a mere 90 restatements. By 2006, that figure had grown 18-fold to 1,577. The average company that made a restatement during this period had average annual revenues of US$1.65 billion.

To shed light on this phenomenon, the U.S. Treasury commissioned a study by Susan Scholz, associate professor of accounting at the University of Kansas School of Business. Released this past April, Scholz's report contains a wealth of data as well as some surprising, or at least counterintuitive, findings.

"I bought into the idea that all of the restatement activity was driven by the Sarbanes–Oxley Act," she says. "It bothers me that people want to boil it down to a single thing."

A Dubious Decade

The rise in the number of restatements from 1997 to 2006 is attributable in part to a three-year economic downturn that began with the bursting of the tech bubble in March 2000. Other factors included the implementation of the Sarbanes-Oxley (or SOX) Act in July 2002 and continuing changes in accounting regulations throughout the period. In total, investors saw 6,633 restatements during the decade.

Restatements began escalating in 2001, even before the rash of corporate accounting scandals that included Enron, Worldcom, and Adelphia, among others, and reached a peak during 2006. Fraud played a hand in 29 percent of restatements in 1997, although there were only 26 such incidents. By 2006, however, only 5 percent of all restatements could be attributed to fraud, while the total number of companies making restatements had increased by 1,250 percent to 350 incidents.

"Most restatements are not fraud," says Jeffrey Szafran, managing director of Huron Consulting Group in Chicago. "Often, at the end of the day, there are people who tried to get it right but didn't."

Similarly, the share of revenue-related restatements decreased from 41 percent of all restatements in 1997 to a much smaller 11 percent in 2006. In 88 percent of all restatements, a restating company's income was reduced.

Over the decade, restatements related to core operating expenses (such as from ongoing operating expenses) accounted for nearly 40 percent of total restatements. Another one-third of restatements involved non-core operating expenses (especially misaccounting for impairment charges, derivatives, taxes, and convertible debt interest). Restatements related to revenue accounted for nearly 20 percent of all restatements, while reclassification and disclosure issues accounted for only 7 percent of restatements. The study also found that in 1997, the average period for restatements was 1.25 years. By 2006, the average was 2 years.

Larger companies tended to restate their financial results in order to correct accounting for asset valuations, derivatives, leases, and taxes. Smaller companies tended to correct accounting for debt/interest, operating expenses, and stock-based compensation. Larger companies were also more likely to make restatements because of fraudulent activities.

Notably, Scholz found that most of the decade's restatements involved companies that did not trade on the major U.S. stock exchanges. Moreover, except for 1997, more than half of the companies that issued financial restatements had reported losses in the prior year.

As for types of companies, manufacturers had the highest incidence of restatements throughout the decade (between 24 percent and 31 percent). Tech companies were generally the second-largest group to restate through 2002, but beginning in 2003, financial and service companies outpaced tech firms as the second most frequent groups restating results. Transportation companies were least likely to restate.

Impact

Bad news tends to drive down a company's stock price at the time of announcement. With regard to restatements, Scholz found that over a two-day window (with the first day being the day of the announcement and the second being the following trading day) the average return on a company's stock price was –9.5 percent from 1997 to 2000. Even as restatements were proliferating, however, companies restating from 2001 to 2006 saw their stock prices initially return –1.3 percent. Not surprisingly, the study found that restatements caused by fraud or those

KEY POINTS

- The number of restatements related to fraud has increased, but fraud now accounts for a smaller proportion of all restatements.
- An initial wave of restatements related to Sarbanes–Oxley has receded.
- Investors appear to have become desensitized to restatements, and stock prices are no longer exhibiting the same negative impact of restatements.

that decreased a company's income had the greatest negative impact.

Longer term, except for the years 1999 and 2003, stocks of companies issuing restatements had an average one-year decline of 4 percent. The median subsequent one-year return among all restating companies was –17 percent.

One trend is clear but curiously so. Overall stock market reaction to a company's financial restatement became much less punishing over the decade. In 1997, the average one-year decline in the company's stock price was about 48 percent. By 2006, the median one-year decline had shrunk to about 2 percent. Interestingly, in both 1999 and 2003, average one-year returns were positive—about 12 percent.

"The sheer volume of restatements has desensitized analysts and institutional investors as well as regular investors," says Martin Wilczynski, senior managing director of forensic and litigation consulting in the Washington, DC, office of FTI Consulting.

Not everyone agrees. "I don't think financial analysts are becoming desensitized, especially those that can quickly decide what is benign and what is important," comments Bill Simpson, a special director in the Los Angeles office of LECG, a global services firm.

"It's not that we're becoming desensitized," says Scholz, "but rather that there was an overreaction in earlier years, the heady days when everything was great and the market was going up every day."

Whither the Future?

Will the financial restatements increase? The Treasury report suggests that a return to a more difficult market environment could lead to an increase in restatements. Although such an impact has yet to be confirmed, the tide may have turned already.

A February 2008 report from Audit Analytics, a research firm based in Sutton, Massachusetts, shows that restatements dropped in 2007 by 31 percent from 2006 levels. The report concludes that this decrease appears to indicate that publicly traded companies are adapting to the new financial reporting conventions attributed to SOX.

In addition, according to data from San Francisco research firm Glass Lewis, first quarter 2008 restatements are down 21 percent from 2007.

Many believe that SOX-mandated regulations (including top executives' attestations of financial statements and the much debated Section 404 requirement that firms document internal control systems) will reduce the number of restatements in the future. Proponents of this interpretation see the initial rash of restatements in 2004 and 2005 as a good thing. In their view, companies were purging their old procedures and were less inclined to push the accounting envelope.

But SOX has another consequence. Companies are now more concerned with not restating when necessary. That concern has replaced previous worries over investor lawsuits stemming from any restatement. "The pendulum has swung the other way, and more companies are afraid of *not* restating," says Cindy Fornelli, executive director of the Center for Audit Quality, a Washington, DC-based group whose mission is to foster confidence in the audit process.

Moreover, the potential convergence of U.S. GAAP and International Financial Reporting Standards (IFRS) could lead to a new round of restatements. "The transition to IFRS could create an initial wave of restatements, as more judgments will be required," says Chris Mann, senior vice president of financial advisory services at MorganFranklin, a professional services firm based in MacLean, Virginia.

But others contend that the less prescriptive, more principles-based reporting standards could actually ease issues. "I think with IFRS we'll see fewer restatements because there will be more judgment in accounting rules, but we may see more challenges to accounting from regulators, analysts, and auditors," notes Szafran of Huron Consulting. "A rules-based system, in some respects, makes it easier to determine that a restatement is necessary."

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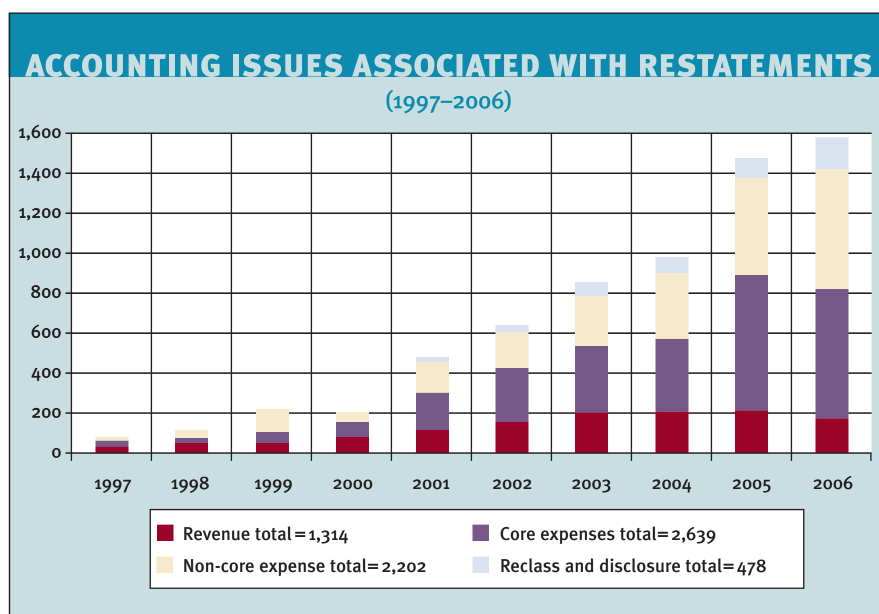

RECOMMENDED RESOURCES

"The Changing Nature and Consequences of Public Company Financial Restatements, 1997-2006"
U.S. Treasury Department report
(www.treas.gov)

"Value Destruction and Financial Reporting Decisions"
Financial Analysts Journal (Nov/Dec 2006)
(cfapubs.org)

"Accounting Restatements: Are They Always Bad News for Investors?"
Summarized in the *CFA Digest* (February 2007)
(cfapubs.org)