

Financial restatements: understanding differences and significance

Corporate officers, auditors and audit committees are all involved in the efforts of US publicly traded companies to provide accurate corporate financial reports to investors. But, sometimes mistakes make their way into financial statements of public companies, and when they do, what happens next can vary depending on the timing and severity.

When a financial statement error is discovered, it should be corrected. In some cases, the correction of an error is made through a restatement, which may lead to questions from investors and other stakeholders. When an error dates from a prior year – or years – how it is corrected can vary, based on the significance of the error to prior year financial statements. All of this can make it difficult for investors to understand the difference and significance of financial restatements. This article seeks to shed some light on such considerations.

Responsibilities

Corporate officers are required to certify that quarterly and annual financial statements “fairly present, in all material respects, the financial condition and results of operations of the issuer.” A company’s independent auditor provides an opinion on such financial statements and is required to “plan and perform an audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud.” Audit committees, which must be comprised of individuals independent of management, oversee and monitor management’s and the independent auditor’s participation in the financial reporting process.

Management often is the first to identify an error, but errors are also identified by internal and external auditors and occasionally by others, such as the U.S. Securities and Exchange Commission (SEC) and the Public Company Accounting Oversight Board (PCAOB). When and how they are corrected, can vary based on the materiality of the error.

It is important to remember that restatements are rare and not all restatements are the same. Clear explanations from the company can help answer investor questions about the restatement, such as what effect did the mistake have on past results? What impact will it have on the future? Is there something the investor should consider when forecasting future performance? What comfort level should investors have that similar issues are unlikely to reoccur?

To avoid misunderstandings, the company should consider discussing:

- ▶ The type of error
- ▶ The cause of the error
- ▶ How the error was discovered
- ▶ How the error was corrected
- ▶ Whether there are any ongoing ramifications
- ▶ The implications to a company’s control environment

What is a restatement?

The Financial Accounting Standards Board (FASB) defines a restatement as a revision of a previously issued financial statement to correct an error. The determination of whether a prior period error will result in a restatement hinges on materiality. While the FASB clearly defines restatement, it provides little guidance on assessing materiality. The SEC, however, instructs companies and auditors to conduct a quantitative and qualitative analysis to determine if an error is material to the prior period financial statements. Some refer to “rules of thumb” when quantitatively assessing materiality (e.g., 5% to 10% of pretax income), but there are no bright-line percentages or figures for materiality.

“Big R” restatements

When an error is material to prior period financial statements, a company is required to restate previously issued financial statements and correct the error (e.g., in a Form 10-K/A filing or, in some cases, the next Form 10-K filing). In such situations, the audit opinion also is revised to disclose the restatement and refers to the financial statement footnote that describes the error and related correction. This type of restatement is commonly known as a Big R restatement.

Because Big R restatements are material corrections to previously issued financial statements, investors will want to understand the nature of the error and the correction. There is a rebuttable presumption that a Big R restatement results from one or more material weaknesses in internal control. Thus disclosure of the Big R restatement frequently is accompanied by disclosure of a previously undetected material weakness in internal control over financial reporting.

“Little r” restatements

There are occasions when an error is discovered that was not material to prior period financial statements. Such an error, while immaterial to each individual year, could accumulate over time to a material amount. If the error accumulates to the point that making an all-at-once adjustment to fix the accumulation of past year errors in the present year alone could materially misstate the current year’s financials, the company would adjust or “restate” the prior period information in the current period financial statement. This is sometimes referred to as a Little r restatement.

In a Little r restatement, the company would still need to disclose the correction in the footnotes of the current period financial statements (i.e., the financial statements that reflect the correction), but would not have to amend prior Form 10-K filings. Little r restatements also do not require the independent auditor to modify its opinion because the prior period financial statements were not materially misstated.

Little r restatements are not material to the prior period financial statements, but investors should understand the nature of the error and the related correction. In some instances, the company may determine that, while not material, the little r restatement resulted from deficiencies in internal controls that could have resulted in a larger restatement and thus also disclose a material weakness in internal control over financial reporting.

Other immaterial errors

If an error is immaterial to the prior period financial statements and fixing it in the current period financial statements would not materially misstate the current period, the error would be corrected in the current period financial statements. In our view, when an error is discovered – even if it is immaterial – it is a leading practice to correct the error in the current reporting period.

As noted, a material restatement (i.e., a Big R restatement), which must be filed on an amended Form 10-K with a revised opinion from the independent auditor, is a relatively rare occurrence. In most years, less than 1% of the Big Four’s client base files such a restatement.¹

Assessing restatements and company responses

Because the causes of restatements vary, there is a variety of factors for investors to consider when assessing a restatement. These include:

- ▶ The cause and significance of the error
- ▶ The likelihood of its reoccurrence
- ▶ The preventive measures, including consideration of internal controls, the company is employing to prevent such an error from happening again

To find out more information about a restatement and how the company is addressing the underlying problem, investors can look to the company’s disclosure documents, including the disclosure in the financial statement footnotes (e.g., Form 8-K and Form 10-K/A filings for a Big R restatement and Form 10-K for a Little r restatement), as well as any communications related to the matter on calls with analysts. Where a company puts information regarding Little r restatements in the footnotes varies, as there is no prescribed section.

The importance of clear communications to investors regarding a restatement cannot be underestimated. Companies can help investors be more comfortable with news surrounding a restatement by thoroughly explaining the issue or issues that gave rise to the error and how the company is responding, including any corrective actions. Failing to do so may increase concerns about whether there is an ongoing weakness in the company or its management, which could lead to additional problems down the road.

Ambiguity regarding how a company is responding to financial reporting errors can be the most damaging, because it may prompt the investment community to assume that the problem is more significant than it is in reality.

Endnote

- 1 Errors related to the accounting for income taxes and revenue recognition are consistently the leading areas that give rise to restatements.

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