Recent years have seen a significant increase in the number of financial statement restatements. According to the Government Accountability Office (GAO), the number of financial statement restatements identified each year rose from 92 in 1997 to 225 in 2001, with some 10 percent of all publicly traded companies releasing at least one restatement from January 1997 through June 2002. Despite the passage of the Sarbanes-Oxley Act in 2002, the number of restatements for U.S. companies continued to rise in subsequent years to encompass 513 restatements in 2003 and 627 in 2004, while the number of restatements soared to 1,255 and 1,420 restatements in 2005 and 2006, respectively. To put this data in perspective, it is important to understand the leading causes of misstatements in the financial statements and the effects of restatements. This article explores the issue of restatements for publicly traded companies since the ability to gather such information for non-public companies is difficult, especially when trying to confirm the accuracy of the information.

Types of Misstatements

Little consensus exists regarding the single leading cause of financial statement restatements because the leading cause changes from year to year. In separate studies revenue recognition was found to be the leading cause for restatements. However, in 2006, expense recognition was the most common type of error while another study concluded that equity errors were the leading cause of misstatements. Even though causes of financial statements misstatements change from year to year, the main accounting issues causing misstatements have remained fairly stable. A description of the prevailing types of misstatements follows.

Revenue Recognition

Staff Accounting Bulletin 101 (SAB 101) outlines the four criteria for recognizing revenue: (1) evidence of an arrangement such as a signed arrangement or an established historical business practice; (2) delivery has occurred or services have been rendered, which should be evident with title transfer or documentation of services provided; (3) the price is fixed and determinable with payment obligation evident, including concessions, discounts or contingencies and any unfilled commitments by the seller; and (4) collectibility is reasonably assured and any unpaid amount can be reasonably estimated or the client has the financial resources to pay the remaining amount. In general, if a potential revenue item does not meet these four criteria, revenue should not be recognized. Common revenue misstatements involve percentage-of-completion accounting, transactions with consignees, transactions with repurchase obligations and bill and hold transactions.

Expense Recognition

Improper expense recognition includes a variety of accounting practices designed to achieve an overstatement of net income either by intentionally understating expenses or improperly deferring them to future periods. A common technique used to manipulate expenses is the setting up of “cookie jar” reserves. The intended result is to manage earnings by creating an initial overstatement of expenses in earlier periods, then netting the excess reserves against expenses in future periods to create a smooth upward trend in net income. Other methods utilized to understate expenses include: (1) failure to record expenses or losses via improper capitalization/deferral or through lack of accrual; (2) overstating ending inventory values to reduce cost of goods sold; (3) understating bad debts or loan losses; and (4) failure to record asset impairments.

Equity Errors

Restatements driven by misstatements in equity accounts primarily arise from improper accounting for earnings per share (EPS), stock-based compensation, stock options, warrants and convertible securities. Equity-driven restatements rose by 77 percent in 2005. The stock option backdating scandals that plagued companies in 2004 caused the financial accounting standards board (FASB) to respond with a revision to FAS 123 that requires “a public entity to measure the cost of employee services received in exchange for an award of equity instruments based on the grant-date fair value of the award.” For example, companies must show the fair value, determine by an option-pricing model, of any stock option awards on their income statements. Often companies showed the Black-Scholes value of their stock options in the income statement footnotes, not as a line item on the statement.

Misclassification

Misclassification refers to improperly classifying items in the balance sheet, income statement or statement of cash flows. Cash flow related misclassifications appear to be the most prevalent. Allocating cash flows among operating, investment and financing activities does not change total net cash flow, but does affect the balance among the three categories. The statement of cash flows is used as an additional gauge to assess the quality of a company’s earnings – more specifically, how much cash a company is generating to support its operating activities. If a company’s cash flow from operating activities is significantly lower than its earnings, investors should beware.

Disclosure of Restatements

Public companies are required to disclose restatements by filing amended SEC (Security and Exchange Commission) annual and quarterly filings on Form 10-K/A or 10-Q/A which contain the corrected (restated) financial statements. Additionally, in 2004 the SEC began requiring that public companies also announce restatements using Form 8-K, item 4.02. However, because of the SEC’s flexibility in filing Item 4.02 disclosures, many companies have been engaged in a practice known as “stealth restatements,” in which companies employ trickery to avoid publicly announcing restatements. continued on page 6
Public companies generally use three tricks to keep restatements out of the spotlight. The first trick involves restating without filing the necessary amended 10-K or 10-Q reports. Instead, companies merely restate previous periods’ financial reports by tucking them in the next regularly scheduled quarterly or annual filings, causing investors to take little notice. The second trick is for companies to restate the financial statements, but not issue a press release alerting investors to the change. This strategy may seem fairly obvious, but does indicate intent to downplay restatements by minimizing communication to investors. The third trick is called “file late, keep quiet, then restate.” In 2005 nearly two-thirds of restating companies were late in filing a quarterly report or an annual report during the year. A key assumption in employing this trick is that the investors are unaware of a company’s intention to restate. Many companies then fail to adequately explain the reasons behind the postponement of annual or quarterly reports in their NT filings. Overall, some 40 percent of restating companies failed to take all the steps necessary to disclose the restatements in the proper way.

Implications of Restatements
Effects on Stock Price and Market Cap
Restating financial statements can cause a wide variety of market responses, but overall the market tends to react negatively to such news. On the positive side, restatements often specify which item was improperly reported in the original statement. This information allows investors and other users of the financial statements to study the marginal importance of these items on the company’s operations and market cap. For instance, the GAO’s report found that revenue restatements had the largest negative effect on market capitalization loss during the period studied, accounting for over half of the market cap lost, but only 39 percent of the total restatements. Restatements related to mergers and acquisitions accounted for only six percent of the restatements, but caused 20 percent of the market cap losses. In contrast, improper or questionable accounting for expenses comprised 14 percent of restatements in the period studied, but accounted for only 4.8 percent of the negative market cap impact.

In general, restatements reflect poorly on management and give investors the impression that management is incompetent or intentionally attempting to defraud investors. Previous studies have shown that restatements are related to a decline in firm value, a decrease in future earnings prospects and an increase in the cost of capital. The most immediate and pronounced market reaction to financial restatements is a significant drop in the offending company’s stock price and market capitalization. According to the GAO, the stock price of restating companies dropped by an average of 10 percent during the three trading days surrounding the restatement. The stock prices remained depressed for long periods following the restatement, although the GAO report concedes that other factors may have contributed to these price depressions.

Conversely, the GAO found that restatements related to restructuring, asset impairment and inventory issues actually contributed to an increase in market capitalization of some $2.9 billion during the period studied. Salaveti and Moore also found evidence to support this phenomenon, noting that a restatement can lead to less uncertainty regarding the future of a company, which results in positive market reaction. They further maintain that estimates such as “bad debt reserves, restructuring charges, pension plan rates of return, long-term restructuring plans and securities-related entries … are inherently imprecise” and that such increased certainty regarding estimates positively alters the precision of investors’ information set.

Implications for Investor Confidence
Evidence also suggests that restatements negatively affect investor confidence. Investor confidence is by nature difficult to quantify because investors use several types of information in making investment decisions. However, one key indicator shows the impact of restatements on investor confidence.

The UBS Index of Investor Optimism shows that investor optimism plunged in the wake of the Enron and WorldCom accounting scandals. In a press release dated May 28, 2002, the Index registered at 90. In that poll, investors were asked about conditions that could be detrimental to the U.S. investment climate. Eighty-four percent of the investors polled stated that the issue of questionable accounting practices was negatively affecting the markets. In addition, nearly three-quarters of the investors stated that such accounting concerns were widespread in the business environment.

Regulatory Environment
In the late 1990s, the SEC recognized the need for closer scrutiny and enforcement of securities laws relating to accounting violations. The first step directed SEC staff to create accounting guidance regarding proper revenue recognition. The direct result of this consideration was the release of Staff Accounting Bulletin 101. At the time of SAB 101’s release, revenue recognition practices accounted for nearly half of the SEC’s accounting-related enforcement cases. The second step mandated SEC staff reviews of public companies that announce practices such as major write-offs or the restructuring of liability reserves that appeared to be attempts at earnings management. The SEC began investigations in 1999 which resulted in 30 enforcement actions against 68 companies and individuals for fraud and misconduct. The most obvious implication of restatements is the passage of the Sarbanes-Oxley Act in 2002.

Conclusion
Financial statement restatements, which have increased rapidly over the last few years, have had far-reaching implications. The causes may vary by year, but tend to remain in four narrow areas: revenue recognition, expense recognition, equity errors and misclassifications. The impact of restatements has caused significant reaction from the stock market, individual investors and regulatory authorities. The loss of investor confidence led Congress to pass Sarbanes-Oxley as a necessary response to regaining public confidence in the financial reporting of public companies. Many see the Act as a way to ensure more
accurate financial reporting, while others do not believe the benefits justify the cost of complying with the law. In addition, venture capitalists are concerned that the high legal and auditing fees associated with Sarbanes-Oxley are driving companies to take initial public offerings overseas\(^9\) which would involve reporting within International Accounting Standards. Restatements, the causes and effects, is an area that is likely to continue an active debate between both the profession and the investment community.

**Endnotes:**

5. Grothe.
10. Turner and Weirich.
15. Turner and Weirich.
17. Turner and Weirich.
24. Salavei and Moore
25. The UBS Index of Investor Optimism is a monthly survey that measures the attitudes of private investors. In the survey, investors are defined as households with at least $10,000 of investable assets in the United States. The overall Index is calculated on the basis of seven questions, which cover the personal financial dimension and the macroeconomic dimension of investments. The Index level reflects the balance of optimistic and pessimistic responses. The Index’s baseline point of comparison is 124, established with the inaugural measurement in 1996. For more information, see www.ubs.com/investoroptimism.

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**Other Resources:**


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